Supreme Court, U.S.
FILED
0014 22 MAR 13 2001
OFFICE OF THE CLERK

No. 00-___

In The

Supreme Court of the United States

THE KROGER CO.,

Petitioner,

v.

THE KANSAS DEPARTMENT OF REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The Supreme Court Of Kansas

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Whether the State of Kansas' disallowance of all interest expense deductions attributable to The Kroger Co.'s 1988 $4.1 billion loan, some of which was used to successfully defend against a hostile takeover threat, results in extraterritorial taxation of non-Kansas income in violation of the Due Process and Commerce Clauses of the United States Constitution.

Whether the State of Kansas, by disallowing said interest expense deductions to a non-domiciliary taxpayer, while allowing the same deductions to taxpayers domiciled in the State, discriminates against interstate commerce in violation of the Commerce Clause of the United States Constitution.

LIST OF PARTIES

The parties to the proceeding below were the same as those mentioned in the present caption.

RULE 29.6 STATEMENT

The Kroger Co. has no parent corporation. There is no publicly held company that owns 10% or more of Petitioner The Kroger Co.'s stock.

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PETITION FOR A WRIT OF CERTIORARI

This petition for a writ of certiorari respectfully seeks this Court's review of the judgment of the Supreme Court of Kansas.

OPINIONS BELOW

The final, corrected opinion of the Supreme Court of Kansas in this case is not officially reported, but is reproduced in Appendix A at 1a-15a to this Petition. The original opinion of the Supreme Court of Kansas (App. E at 34a-49a) is officially reported at 12 P.3d 889 (Kan. 2000). Following filing of its original opinion, but before issuing its corrected opinion, the Supreme Court of Kansas issued a modified opinion, a copy of which appears in Appendix C at 17a-31a to this Petition.[1] The opinion of the Supreme Court of Kansas denying The Kroger Co.'s motion for rehearing (App. J at 92a) is unreported. There is no opinion of the Court of Appeals of the State of Kansas. The order transferring the case from the Court of Appeals of the State of Kansas to the Supreme Court of Kansas (App. F at 50a) is unreported. The orders of the Board of Tax Appeals of the State of Kansas (App. G at 51a-54a and App. H at 55a-75a) are unreported. The written final determination of the Secretary of Revenue of the Kansas Department of Revenue (App. I at 76a-91a) is unreported.

[1] Hereafter, all references to the Supreme Court's decision will refer to the corrected opinion found in Appendix A at 1a-15a.

JURISDICTION

The order of the Supreme Court of Kansas denying Petitioner's motion for rehearing was entered on December 15, 2000. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides: "The Congress shall have Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes."

The Due Process Clause of the United States Constitution, U.S. Const. amend. XIV, § 1, provides: "[N]or shall any State deprive any person of life, liberty, or property, without due process of law. . . . "

Relevant portions of the Kansas statutes are set forth in Appendix K at 93a-102a.

STATEMENT

Petitioner, The Kroger Co. ("Kroger" or "the Company"), challenges a tax assessment issued by the Kansas Department of Revenue ("Department") that results in extraterritorial taxation by Kansas and discriminates against interstate commerce. The Department has disallowed all interest expense deductions that arise from debt undertaken by Kroger as part of a major restructuring of

its capital structure to (a) retire existing long-term debt; and (b) successfully defend against an attempted hostile takeover.

The Department's position violates the unitary business principle articulated by this Court in a series of cases over recent decades, *see, e.g., Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992); *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980); *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980), by inflating the apportionable tax base in Kansas by arbitrarily disallowing interest expense integrally related to the business conducted by Petitioner within that State. The result of such an arbitrary and improper disallowance of an interest expense deduction, as this Court recognized in *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458 (2000), is the extraterritorial taxation by Kansas of income earned outside its borders, in violation of the Due Process and Commerce Clauses of the U.S. Constitution. Additionally, because Kansas' tax scheme deprives only entities domiciled outside the State of the deduction claimed by Kroger, while allowing the same deduction to entities domiciled within the State, it discriminates against interstate commerce in violation of the Commerce Clause.

1. Kroger's Unitary Business and Its Kansas Activities

The facts of this case, which were stipulated, are not in dispute. Kroger is an Ohio corporation operating retail food and grocery stores. During the period at issue, the tax years ending December 30, 1989 through January 2,

1993 (the "Audit Period"), Kroger, by itself and through its subsidiaries, conducted business in Kansas and numerous other states.

2. The Borrowing Activities at Issue

In 1988, Kroger borrowed a substantial amount of money, $4,190,744,000, from various lenders. It directed the borrowed funds to two ends. It devoted $846,537,000, or 20.2% of the funds, to retire existing long-term debt held by the Company. It devoted the remainder of the amount borrowed, or 79.8% of the new debt, to fund the payment of dividend distributions to shareholders in the aggregate amount of $3,347,028,000. App. I at 77a.

In a joint letter to shareholders prior to the distributions, Lyle Everingham, the Chairman of the Board of Directors and Chief Executive Officer of the Company, and Joseph Pichler, the President and Chief Operating Officer of the Company, characterized the distributions as an "integral part" of a major restructuring of the Company's operations and capital structure. The officers stated: "As part of the program the Company has reviewed and adopted a strategic operating plan which will focus upon the Company's core businesses of supermarkets and convenience stores." The stated plan involved, among other activities: focusing on geographic areas in which the Company's stores enjoyed a superior market share position, focusing on higher margin store formats, divesting non-core and underproductive assets, reducing capital expenditures, and instituting cost control strategies.

Kroger undertook these restructuring efforts, in part, to avert a hostile takeover of the Company. Kroger's management believed that the best interests of the Company's shareholders were served by remaining an independent, publicly traded entity. By offering shareholders a substantial distribution, selling various assets, and increasing Company debt, management made a takeover less attractive to would-be hostile acquirers. In a prospectus issued to shareholders, the Company indicated that it would pay the dividend, in large part, from capital surplus.

3. Kroger's Income Tax Return Filing Position

For the years at issue, Kroger deducted from its pre-apportioned tax base the interest expense it incurred in servicing its debt. The parties have stipulated that the entire interest expense deduction which the Department disallowed represents an "ordinary and necessary expense" under Section 162 of the Internal Revenue Code and, accordingly, that the amount "was properly deducted . . . on Taxpayer's federal income tax return." App. I at 77a. The parties also have stipulated that Kroger treated the interest expense on its Kansas returns in exactly the same manner as it treated the expense on all returns it filed in other states: "Taxpayer has consistently apportioned such interest expense on its state income tax returns filed in Kansas and other states." App. I at 77a. During the Audit Period, Kroger either filed returns of its own, or was included in combined returns filed by affiliates, in more than 30 states. In years prior to the Audit Period, Kroger had taken, and the Department had

allowed, expense deductions for the debt the new borrowings replaced.

4. Kansas' Taxing Scheme

Like most other states, Kansas uses a corporate taxpayer's federal taxable income as the starting point for determining Kansas taxable income. Kan. Stat. Ann. § 79-32,138(a) ("Kansas taxable income of a corporation taxable under this act shall be the corporation's federal taxable income for the taxable year with the modifications as specified in this section."). For corporations conducting business within and without the State, Kansas determines the share of the taxpayer's income attributable to the State pursuant to a series of statutes known collectively as the Uniform Division of Income for Tax Purposes Act, or UDITPA. Adopted in whole or in large part by 22 states and the District of Columbia, UDITPA is designed to distribute a multi-state entity's taxable income across the jurisdictions in which it operates in a manner that is uniform and that minimizes multiple taxation. Unif. Div. of Income for Tax Purposes Act, Prefatory Note, 7A Pt. I U.L.A. 357 (1957).

UDITPA attempts to accomplish its aim of equitable distribution of income, first, by separating those items of income properly subject to tax by all of the states in which a taxpayer operates its business from those items of income properly subject to tax by only a single state. The former category of income is termed "business income," and the latter, "nonbusiness income." Once the items of income are properly classified, UDITPA "allocates" each item of nonbusiness income, in full, to a

single jurisdiction, pursuant to specified rules. Kan. Stat. Ann. §§ 79-3274 through 79-3278. UDITPA then distributes, or "apportions," the remaining income (*i.e.*, the business income) among the states in which the taxpayer conducts its business pursuant to a stated formula. Kan. Stat. Ann. § 79-3279. The precise mechanics of UDITPA's scheme of allocation and apportionment are not material to this dispute.

However, of critical relevance to this matter is how UDITPA (and therefore, Kansas' statutes) define the categories of business and nonbusiness income, and particularly, how Kansas has chosen to interpret those definitions in its arbitrary disallowance of Kroger's interest expense deductions. Kansas law defines "business income" in the following manner:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Kan. Stat. Ann. § 79-3271(a). "Nonbusiness income" is defined in a complementary fashion as "all income other than business income." Kan. Stat. Ann. § 79-3271(e).

The states that have adopted UDITPA differ materially in their interpretation of the definition of "business income." Generally, the states fall into two broad categories, with some maintaining that the definition encompasses a single test, termed the "transactional test," and others maintaining that the definition encompasses two

tests, the transactional test and a distinct "functional test."

During the period involved herein, Kansas fell within the former category, as it recognized only a "transactional test" for identifying business income under its statute. *See, e.g., Western Natural Gas Corp. v. McDonald*, 446 P.2d 781 (Kan. 1968). The transactional test focuses on the first part of UDITPA's definition of "business income" – the reference to "income arising from transactions and activity in the regular course of the taxpayer's trade or business" – and asks whether the *transactions* giving rise to the item of income in question represent normal or customary activities within the taxpayer's business. I Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* ¶ 9.05[2][a] (3d ed. 1998).

5. The Assessment

On June 26, 1996, the Department issued to Kroger an assessment (the "Assessment") in the amount of $10,527,189. App. I at 77a-78a. The Assessment consisted of $5,145,161 in additional tax, $4,095,734 in interest, and $1,286,294 in penalty. The Assessment resulted from the Department's contention that Kroger improperly treated the interest expenses associated with servicing the Company's debt as a business expense, deductible from apportionable net income. The Department classified the expense as an alleged "nonbusiness expense," and disallowed all of it. This classification dramatically increased Kroger's apportionable income, and accordingly, dramatically increased Kansas' share of that apportionable income.

Again, there is no dispute that Kroger treated the interest expense as an apportionable expense on all returns filed with other states; it did not allocate the expense on any return. App. I at 77a. No other state, including many which have adopted UDITPA's apportionment scheme, has challenged Kroger's apportionment of the interest expense.

6. The Proceedings Below

How the federal question was raised and passed on below. In its pleadings filed below, Kroger consistently raised two arguments of constitutional significance. First, the Company argued that the Assessment violated the unitary business principle and its commandments concerning the proper classification of income, by excluding from Kroger's apportionable tax base items of expense integrally related to the Company's conduct of its business operations in Kansas and other states. Kroger repeatedly cited this Court's decisions in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980), *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980), and *General Motors Corp. v. Washington*, 377 U.S. 436 (1964), all of which addressed the constitutional limitations, under both the Due Process and Commerce Clauses, upon states' taxation of income earned by multi-state taxpayers. In particular, the Company raised this challenge in its last substantive brief filed before the Supreme Court of Kansas' decision. The Kansas Board of Tax Appeals and the Supreme Court of Kansas determined that the Department properly classified the interest expenses as nonbusiness expenses. App. H at 66a-67a; App. A at 15a.

Second, Kroger argued below that the Assessment resulted in multiple taxation of the Company's income. The Supreme Court of Kansas recognized in its decision that Kroger had raised the specter of "duplicative taxation." App. A at 8a. That court passed on the issue by upholding the Assessment.

The decisions below. Following receipt of the Assessment, on August 20, 1996, Kroger timely filed a petition for reconsideration with the Office of Administrative Appeals for the Kansas Department of Revenue. By decision dated May 19, 1998, the Secretary of Revenue of the Department denied the petition in a written final determination. App. I at 76a-91a. On June 3, 1998, Kroger filed a timely appeal of the written final determination with the Board of Tax Appeals of the State of Kansas (the "Board"). After hearing oral argument, the Board, on July 21, 1999, denied the Company's request for relief by a 4-1 majority. App. H at 55a-75a.

Board Member Frey issued a dissenting opinion, in which he challenged the majority's determination that Kroger's debt expenses could not be deducted because the Company undertook the borrowing, in part, to fend off a hostile takeover. Member Frey stated:

> Hostile takeovers do not occur often in the life of a corporation. That does not mean the measures taken by the corporate officers to fend off such an effort should be regarded as activity that is not related to the business of the corporation. . . . Hindsight leads me to believe it was an astute business decision that possibly saved the company.

App. H at 72a-73a (citation omitted). He further concluded: "Financial management of a publicly held corporation is something that must be done in the regular course of taxpayers' trade or business." App. H at 73a. Kroger filed a petition for reconsideration with the Board, which the Board denied on August 19, 1999. App. G at 51a-54a.

Kroger timely appealed the Board's decision to the Court of Appeals of the State of Kansas. After filing its opening brief, the Company filed a motion to transfer with the Supreme Court of Kansas, which the Supreme Court granted. App. F at 50a. The Supreme Court of Kansas affirmed the Board's order. App. A at 1a-15a.

As noted previously, the State Supreme Court twice amended its original decision (App. E at 34a-49a), first by issuing a "Modified Opinion" (App. C at 17a-31a), and then by issuing a "Corrected Opinion" (App. A at 1a-15a). The amendments generally corrected minor factual misstatements in the original opinion.

REASONS FOR GRANTING THE PETITION

I.

KANSAS' DISALLOWANCE OF KROGER'S INTEREST EXPENSE DEDUCTIONS VIOLATES THE UNITARY BUSINESS PRINCIPLE, THEREBY RESULTING IN THE STATE'S TAXATION OF EXTRATERRITORIAL VALUES AND THE IMPOSITION OF A MULTIPLE TAX BURDEN UPON KROGER

A. This Court Has Held Repeatedly That States May Not Tax Values Earned Outside Their Borders.

Among the most fundamental precepts of state taxation is this: a tax on interstate activities will withstand

scrutiny under the Due Process and Commerce Clauses of the U.S. Constitution only if there exists "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the State and the intrastate values of the enterprise.' " *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 219-20 (1980) (quoting *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436, 437 (1980)); *see also Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983) (same); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982) ("As a general principle, a State may not tax value earned outside its borders."). Where no such connection exists, the state has not "given anything for which it can ask return." *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940); *see also ASARCO*, 458 U.S. at 315.

A state may not tax more than the state's fair share of a multi-state enterprise's income. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), the Court stated that, to comport with the Commerce Clause, a tax must satisfy four tests. It must: (1) be applied to an activity with a substantial nexus with the taxing state; (2) be fairly apportioned; (3) not discriminate against interstate commerce; and (4) be fairly related to the services provided by the state. *Id.* at 279.

In explicating the second prong of the *Complete Auto* test, the Court has stated that a tax will be fairly apportioned only if it is both "internally consistent" and "externally consistent." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995); *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989). External consistency, the aspect of fair apportionment relevant here, "looks . . . to the economic

justification for the State's claim upon the value taxed, to discover whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State." *Jefferson Lines*, 514 U.S. at 185. Put bluntly, to pass constitutional muster, a state's apportionment formula must be "fair." *Container Corp.*, 463 U.S. at 169.

B. Kansas' Disallowance of Kroger's Interest Expense Is Not "Fair," The Deduction Violates the Unitary Business Principle and, Most Notably, Ignores This Court's Decisions in *Allied-Signal* and *Hunt-Wesson*.

The principles of fair apportionment described above find tangible expression through the unitary business principle. This Court has stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Mobil*, 445 U.S. at 439; *ASARCO*, 458 U.S. at 319 (quoting *Mobil*). At bottom, the unitary business principle requires that a state establish some meaningful connection between the item of income it seeks to tax and the in-state activities of the taxpayer before it may tax any portion of that income. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 773 (1992).

Within the past decade, this Court twice has applied the unitary business principle in the context of capital transactions by a taxpayer, and these two decisions bear directly on this case. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992); *Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal.*, 528 U.S. 458 (2000). In *Allied-Signal*,

the Court crystallized much of the unitary business doctrine it had developed over the prior dozen years. In prior cases, the Court had evaluated states' claims to tax particular items of income by looking to whether the recipient of the income had a "unitary relationship" with the payor of the income, as measured by such criteria as centralized management, functional integration, and economies of scale. *See, e.g., Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425 (1980) (evaluating Vermont's taxation of a portion of dividends paid to the taxpayer by foreign subsidiaries); *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354 (1982) (evaluating New Mexico's taxation of dividends received from foreign subsidiaries); *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) (evaluating Idaho's taxation of dividends and interest paid by subsidiaries, and capital gains earned from the sale of stock in subsidiaries).

In *Allied-Signal*, the Court further refined the unitary business doctrine. *Allied-Signal* involved New Jersey's assertion of the right to tax a portion of the capital gain earned by the taxpayer, Bendix Corporation, from the sale of a 20.6% stock interest in another company, ASARCO. The parties had stipulated that "Bendix and ASARCO were unrelated business enterprises each of whose activities had nothing to do with the other," 504 U.S. at 774, and thus, there was no dispute that Bendix and ASARCO lacked a unitary relationship. Nonetheless, New Jersey contended that the gain at issue should be included in the apportionable tax base because, it claimed, Bendix regularly engaged in similar acquisitions and dispositions as part of a long-term corporate strategy. *Id.* at 786-88.

The Court rejected New Jersey's claim. While it acknowledged that prior decisions had analyzed the existence (or lack thereof) of a unitary relationship between the payor and payee of the relevant item of income, the Court stated that such a unitary relationship does not serve as the sole basis for a state's proper assertion of its tax. Indeed, the Court recognized that, where capital transactions are concerned, taxpayers often will lack a unitary relationship with the other party to the transaction, *e.g.*, a bank. *Id.* at 787-88. The Court explained that, in the absence of a unitary relationship, a state still may tax income derived by an in-state taxpayer from capital transactions provided it can demonstrate "that the capital transaction serve[s] an operational rather than an investment function" within the taxpayer's existing unitary business. *Id.* at 787. The Court concluded that New Jersey had failed to make such a showing. It determined that Bendix's equity stake in ASARCO represented a mere "passive investment" that was not "integral" to Bendix's operations. *Id.* at 788.

The Court's recent decision in *Hunt-Wesson, Inc. v. Franchise Tax Board of California*, 528 U.S. 458 (2000), added another important layer to the unitary business doctrine, as, for the first time, the Court explained the workings of the doctrine in the context of *deductions* from apportionable income, rather than proposed additions to apportionable income. In *Hunt-Wesson*, the Court reviewed a challenge to California's statutory scheme for disallowing interest expense deductions. The statute in dispute required any nondomiciliary taxpayer to compute the amount of its interest expense deductible from apportionable income by reducing its total interest expenses by

the amount of interest and dividend income the taxpayer received that were not subject to tax by California (*i.e.*, because it was unrelated to the taxpayer's unitary business in California). *Hunt-Wesson*, 528 U.S. at 461-62. In essence, the statute presumed that any nondomiciliary that borrowed money did so to purchase or carry its nonunitary investments, whether or not the evidence supported that presumption. *Id.* at 466. The Court noted that no other jurisdiction had taken such an approach in allocating interest expenses. *Id.*

The Court struck that arbitrary disallowance of interest expense as a violation of the Due Process and Commerce Clauses. Of significant relevance to this case, the Court recognized that the denial of a deduction for an expense related to a taxpayer's unitary business in the taxing state amounts to an unlawful tax on extraterritorial values:

> California's rule measures the amount of additional unitary income that becomes subject to its taxation (through reducing the deduction) by precisely the amount of nonunitary income that the taxpayer has received. And for that reason, that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax.

Id. at 464-65. Consistent with *Allied-Signal*, the Court in *Hunt-Wesson* advised that, in order to satisfy constitutional strictures, any scheme for attributing interest expense deductions must reasonably reflect the use of the funds that generated the expense. *Id.* at 467-68. In short, expenses related to unitary activities must be deductible from unitary income.

Kansas' disallowance of Kroger's entire interest expense deduction violates the unitary business principle and results in extraterritorial taxation by the State. The borrowings at issue directly related to the unitary business operations that Kroger conducted in Kansas. First, more than 20% of the borrowings simply replaced regular debt that the Company had accumulated through the course of its operations – debt that previously had generated deductions allowed by the State. Second, the remainder of the borrowings immediately and substantially benefited Kroger's operations in the State. By averting a hostile takeover, the borrowings allowed Kroger to maintain its food and grocery operations in the State. Indeed, but for the borrowing, Kroger's business in Kansas may have ceased to exist.

Throughout the proceedings below, the Department contended that the debt expense must be treated as a nonbusiness expense because of the unusual circumstances (*i.e.*, the threat of a takeover) that gave rise to part of the borrowing. App. A at 3a, 14a. The Supreme Court of Kansas endorsed that reasoning when it noted that "the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business." App. A at 15a. Yet, under the unitary business principle, it is not the frequency of the activity giving rise to the income (or expense) that determines whether the item is subject to apportionment; rather, it is the relevancy of the activity to the taxpayer's operations. *See Allied-Signal*, 504 U.S. at 787-88.

Kroger incurred the interest expenses to advance its business activities within and without the State of Kansas. The Department's contention falls apart when one

considers the tax treatment of analogous, unusual events in the lives of many corporations. For example, a corporation may find itself in the position of borrowing substantial amounts of money either to prosecute or to defend a "bet-the-company" piece of litigation. Or, the company may be required to borrow large sums to pay a judgment rendered against it. In each instance, the borrowing serves the purpose of allowing the corporation to preserve its existence. And yet, no taxing authority would contend that these analogous expenses are not deductible from unitary, apportionable income.[2]

C. The Federal Tax Treatment of Kroger's Interest Expense Supports Treatment of the Expense as a Unitary Business Expense for Kansas Income Tax Purposes.

The parties have stipulated that the interest expense at issue constitutes an "ordinary and necessary expense" under Section 162(a) of the Internal Revenue Code that "was properly . . . deducted on Taxpayer's federal income tax return" in the year incurred. App. I at 77a. Section 162(a) provides, in relevant part: "There shall be allowed

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[2] During oral argument before the Board, Member Frey, who ultimately dissented from the Board's majority decision, noted the untenable implications of the Department's posture. He characterized Kroger's borrowings as a "big padlock" intended to "secure the company from this hostile take-over. . . ." He then observed: "Now, if they bought security systems for all their stores to keep out prowlers at night, or if they invested a huge amount of money to stop shoplifters in their tracks, that would certainly be a . . . deductible expense. How would this be different than that?"

as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Expenses that may not be deducted in full in the year incurred under Section 162 generally must be capitalized under Section 263 of the Internal Revenue Code.

The federal treatment of Kroger's expense supports treatment of the expense as a unitary business expense apportionable to all of the states in which Kroger conducts its business. In evaluating whether expenses relating to a takeover are currently deductible or subject to capitalization, the courts and the Internal Revenue Service (the "IRS") have distinguished between expenses relating to a friendly takeover and those arising from defending against a threatened hostile takeover. This Court has held that expenses incurred to facilitate a friendly takeover are subject to capitalization because they produce long-term benefits to the taxpayer that extend beyond the year in which they were incurred. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). In contrast, the courts have concluded that expenses which defend against a hostile takeover produce an immediate benefit and are fully deductible in the year incurred under Section 162. *See, e.g., In re Federated Dep't Stores, Inc.*, 135 B.R. 950 (Bankr. S.D. Ohio 1992). *Cf. NCNB Corp. v. United States*, 684 F.2d 285, 290 (4th Cir. 1982) ("It is a long recognized principle of tax law that expenditures for the protection of an existing investment, the continuation of an existing business, or the preservation of existing income from loss or diminution are ordinary and necessary business expenses within the meaning of IRC § 162."). The IRS' treatment of Kroger's expense as an

"ordinary and necessary expense" comports with this judicial precedent.

Just as the federal tax scheme has recognized that expenses incurred to defend against a hostile takeover directly and immediately benefit the taxpayer's business operations, so too must the unitary business principle acknowledge this fact. Kroger did not incur the expenses to generate benefits over a prolonged period of time, as it might have, for example, were it working to consummate a friendly takeover. Rather, the Company incurred the major part of the expense to produce an immediate benefit, namely, the elimination of a pending threat. And Kroger's entire unitary business – conducted both within and without Kansas – shared in this immediate benefit. Therefore, the Court should affirm that Kroger's ordinary and necessary interest expenses are operational expenses, apportionable in the year incurred to the states in which Kroger conducts its unitary business.

D. Kansas' Violation of the Unitary Business Principle Exposes Kroger to Multiple Taxation of Its Income.

This Court long has held that a taxing scheme will offend the Commerce Clause if it exposes interstate businesses to multiple taxation of income. *See, e.g., Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 255-56 (1938). Here, the multiple taxation of Kroger's income caused by the Assessment is plainly evident. Among all of the states in which Kroger conducts its business, Kansas alone has refused to allow the Company to deduct from its State taxable income an apportioned share of the interest expense at issue. As this Court recognized in *Hunt-*

Wesson, 528 U.S. at 468, such a refusal by Kansas to permit a deduction for expenses related to unitary income "constitutes impermissible taxation of income outside its jurisdictional reach." Therefore, the Court should grant certiorari and strike the Assessment as violative of the Due Process and Commerce Clauses of the U.S. Constitution.

II.

KANSAS' DISALLOWANCE OF KROGER'S INTEREST EXPENSE DEDUCTIONS, WHILE ALLOWING THE SAME DEDUCTIONS TO TAXPAYERS DOMICILED IN THE STATE, DISCRIMINATES AGAINST INTERSTATE COMMERCE IN VIOLATION OF THE COMMERCE CLAUSE

A. The Commerce Clause Forbids Any Tax That, in Purpose or Effect, Discriminates Against Out-Of-State Entities.

For more than a century, the Court has acted aggressively to strike taxes that favor in-state interests over out-of-state interests. *See, e.g., South Central Bell Tel. Co. v. Alabama*, 526 U.S. 160 (1999) (invalidating Alabama franchise tax that measured liability of each non-domiciliary corporation based upon the value of the capital the firm employed within the State, while measuring liability of each domiciliary corporation based upon par value of taxpayer's stock); *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Me.*, 520 U.S. 564 (1997) (invalidating Maine property tax exemption for charitable entities that was limited to entities serving principally in-state residents); *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984)

(invalidating Hawaii liquor tax that exempted certain locally produced beverages from the tax).

The prohibition against discriminatory taxes reflects the central purpose of the Commerce Clause itself, namely, to remove obstacles to the free flow of commerce across state borders:

> "Neither the power to tax nor the police power may be used by the state of destination with the aim and effect of establishing an economic barrier against competition with the products of another state or the labor of its residents. Restrictions so contrived are an unreasonable clog upon the mobility of commerce."

West Lynn Creamery, Inc. v. Healy, 512 U.S. 186, 194 (1994) (citation omitted).

With respect to taxes that facially discriminate against out-of-state interests, the Court has embraced " 'a virtually *per se* rule of invalidity.' " *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641, 647 (1994) (quoting *City of Philadelphia v. New Jersey*, 437 U.S. 617, 624 (1978)). Yet, the Court has indicated just as clearly that it also will strike taxes that, in effect, burden out-of-state entities more heavily than in-state entities. *Best & Co. v. Maxwell*, 311 U.S. 454, 455-56 (1940) ("In each case it is our duty to determine whether the statute under attack . . . will in its practical operation work discrimination against interstate commerce."); *see also American Trucking Ass'ns v. Scheiner*, 483 U.S. 266 (1987) (invalidating Pennsylvania flat highway tax, as applied to interstate truckers, on grounds that the tax effectively imposed a disparate burden on trucks

registered outside the State because those trucks generally used the State's roads less than trucks registered within the State).

B. Kansas' Interpretation of Its Law Imposes Discriminatory Burdens on Interstate Commerce and, Therefore, Must Be Struck.

Kansas' interpretation of its statutes has the effect of imposing greater burdens on taxpayers domiciled outside the State than on taxpayers domiciled within the State. This discrimination takes two forms. First, as demonstrated above, Kroger's interest expenses arose from activities integrally related to the Company's unitary activities in Kansas, and accordingly, the Constitution demands that Kroger be permitted to deduct those expenses from its apportionable, business income. *See* discussion, *supra*, pp. 13-18. Yet, citing various sections of the Kansas statutes, particularly Kansas Statutes Annotated Section 79-3277, the Department has characterized the expense as a nonbusiness expense which Kroger must allocate outside of Kansas. There is no dispute that, under the same approach, the Department would allow Kansas-domiciled taxpayers to allocate all interest expense to Kansas. By allowing Kansas-domiciled taxpayers to deduct all of this item of unitary expense, while denying taxpayers domiciled outside Kansas, such as Kroger, the right to deduct any interest expense, Kansas discriminates against interstate commerce in violation of the Commerce Clause.

Second, the Kansas scheme imposes a disparate burden on non-domiciliaries by treating taxpayers differently

based upon the manner in which they construct their capital structure over time. Kansas has designated the expense at issue as an alleged nonbusiness expense based upon its contention that the transaction at issue – borrowing, in part, to defend against a hostile takeover – was not a regular activity within Kroger's business.

Assuming for the moment the accuracy of this allegation, consider, by way of comparison, how Kansas would treat the taxpayer that (A) is highly leveraged from its inception or (B) borrows smaller amounts on a regular basis in order to create a reserve that it may use should a hostile takeover threat arise. Under these scenarios, Kansas would allow deductions for expenses associated with those borrowings as business expenses, apportionable to Kansas. Thus, Kansas treats taxpayers differently depending upon whether they elect to borrow money at their inception, incrementally, or in one lump sum. To compound this discrimination, only non-domiciliaries are burdened by this differential treatment. Kansas-domiciled counterparts can deduct all three types of borrowings. This disparate treatment of in-state and out-of-state taxpayers again violates the Commerce Clause.

CONCLUSION

For the reasons set forth above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Dated: March 12, 2001

APPENDIX A

Corrected Opinion

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 83,927

In the Matter of the Appeal of
The Kroger Co., from an Order of the
Division of Taxation
on Assessment of Corporate Income Tax.

SYLLABUS BY THE COURT

1.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act.

2.

The Multistate Tax Compact, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4).

3.

K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year.

4.

The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. To be business

income, the transaction and activity must have been in the regular course of the taxpayer's business operations.

5.

Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review.

Appeal from the Board of Tax Appeals. Opinion filed November 3, 2000. Affirmed.

John H. Wachter, of Wright, Henson, Somers, Sebelius, Clark & Baker, L.L.P., of Topeka, argued the cause and *Charles N. Henson*, of the same firm, was with him on the brief for appellant The Kroger Co.

James Bartle, of Kansas Department of Revenue, argued the cause and was on the brief for appellee.

The opinion of the court was delivered by

LOCKETT, J: Multistate taxpayer appeals the Board of Tax Appeals' (BOTA) order disallowing as an apportionable business expense an interest expense incurred to fight a hostile takeover. BOTA classified the expense as a nonbusiness expense, which was allocated to the taxpayer's state of commercial domicile. Taxpayer appealed, claiming its interest expense was a business expense, apportionable to Kansas.

The taxpayer, The Kroger Co. (Kroger), and the Department of Revenue (KDR) stipulated that late in 1988, Kroger, an Ohio corporation operating retail food and grocery stores in Kansas and numerous other states, was the target of hostile takeover attempts by two separate groups. In response to these threats, Kroger's board

of directors determined it was in the best interest of the company and its shareholders to defend against the hostile takeover. To avoid the takeover, Kroger declared a special dividend to its shareholders. To finance the special dividend, Kroger borrowed $4.1 billion. The borrowing of $4.1 billion required Kroger to pay large amounts of interest for the tax years ending December 30, 1989, through January 2, 1993 (the audit period). The interest expenses were declared by Kroger pursuant to the Internal Revenue Code, 26 U.S.C. § 162 (1994), as ordinary and necessary business expenses and deducted by Kroger on its federal income tax return.

KDR determined that Kroger's interest cost associated with the 1988 restructuring was a nonbusiness expense and not apportionable to Kansas. As a result, KDR assessed Kroger additional Kansas income tax of $5,145,161, with interest of $4,095,734 and a penalty of $1,286,294, for a total assessment of $10,527,189. KDR's assessment was based on its determination that Kroger's claimed interest expense resulting from borrowing to deter a hostile takeover was not an apportionable business expense arising from an activity in the regular course of Kroger's business.

The Kansas Income Tax Act, K.S.A. 79-3201 *et seq.*, provides that the Act shall be administered by the Secretary of Revenue or the Secretary's designee for the purpose of ascertaining the correctness of any return. See K.S.A. 79-3233. Kroger protested KDR's assessment by filing a request for hearing with the Secretary of KDR. The Secretary issued a written determination, finding that Kroger's interest expense associated with defending against the hostile takeover bid was not a business

expense incurred in the regular course of Kroger's operations; therefore, the interest expense of Kroger's $4.1 billion debt was a nonbusiness expense.

Kroger appealed the Secretary's determination to BOTA. BOTA found that the regular course of Kroger's business is the retail sale of groceries and that fending off a hostile takeover was not an activity associated with the selling of groceries. By a 4 to 1 majority, BOTA concluded that the interest expense was nonbusiness in nature and should be allocated to Kroger's state of domicile. BOTA later denied Kroger's request for reconsideration. Kroger appealed to the Court of Appeals, and its motion for transfer to the Supreme Court was subsequently granted. Our jurisdiction is pursuant to K.S.A. 20-3017.

Kroger seeks review under the Kansas Act for Judicial Review and Civil Enforcement of Agency Actions (KJRA), K.S.A. 77-601 *et seq.*, claiming BOTA erroneously interpreted the Kansas Income Tax Act or misapplied the law. See K.S.A. 77-621(c)(4). The KJRA provides that the party challenging BOTA's action has the burden to prove that the action by BOTA was erroneous. K.S.A. 77-621(a). See *In re Tax Appeal of Scholastic Book Clubs, Inc.*, 260 Kan. 528, 536, 920 P.2d 947 (1996).

Under the doctrine of operative construction, the interpretation of a statute by an agency charged with its enforcement is entitled to judicial deference. *Blue v. McBride*, 252 Kan. 894, Syl. ¶ 7, 850 P.2d 852 (1993). Despite the deference given to an agency's interpretation of the law it administers, if the court finds that the administrative body's interpretation is erroneous as a matter of law, the court will take corrective steps. *In re*

Tax Appeal of Univ. of Kan. School of Medicine, 266 Kan. 737, 749, 973 P.2d 176 (1999). Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review. *Wasson v. United Dominion Industries*, 266 Kan. 1012, 1018, 974 P.2d 578 (1999).

Statutory Construction of Tax Laws

First, Kroger contends that KDR does not have the statutory authority to disallow the interest expense as a business expense. Kroger notes that the principles and rules of statutory construction of tax laws place the burden on KDR to cite to clear and unequivocal terms within the tax statutes. The principles have been established by the court because of the general nature of the imposition and collection of taxes. Although courts have uniformly recognized that the power to levy taxes is inherent in the power to govern, the exercise of that power is dependent on the existence of legislation creating the tax. Nothing is taxable unless clearly within a taxing statute. *Robbins-Leavenworth Floor Covering, Inc. v. Leavenworth Nat'l Bank & Trust Co.*, 229 Kan. 511, 512, 625 P.2d 494 (1981). Tax laws are statutory and do not exist apart from the statute and, as such, they must be strictly construed. *American Home Life Ins. Co. v. Board of Shawnee County Comm'rs.*, 22 Kan. App. 2d 18, 23, 913 P.2d 1211, *rev. denied* 258 Kan. 857 (1995). Where there is a reasonable doubt as to the meaning of a taxing statute, the statute will be construed most favorably to the taxpayer. *Fleming Co. v. McDonald*, 212 Kan. 11, Syl. ¶ 1, 509 P.2d 1162 (1973). KDR argues that K.S.A. 79-3272 and K.S.A. 79-3274 encompass expenses as a component of net income.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), K.S.A. 79-3271 *et seq.* Neither the Kansas statutes nor the regulations of the KDR define a "nonbusiness expense." However, K.S.A. 79-3272 provides that "net" business and nonbusiness income shall be allocated and apportioned according to UDITPA. The Multistate Tax Compact, K.S.A. 79-4301 *et seq.*, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4). Furthermore, K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year. Expenses, therefore, are a factor in the derivation of net income, and a statutory basis, implicit in the determination of "net" income, exists for making a determination regarding whether a multistate corporation may apportion certain expenses to the various states where it does business. Kroger apportioned part of its interest cost to its Kansas income based upon the UDITPA, the Internal Revenue Code, and its interpretation of the relevant Kansas tax statutes.

Classification of Interest Expense

The borrowing of $4.1 billion to defeat the hostile takeover required Kroger to pay large amounts of interest during the audit period. The calculation of the taxes owed to Kansas by a corporation begins with the corporation's federal taxable income; that income is then subject

to modification as specified in K.S.A. 79-32,138. UDITPA provides that a corporation's business income is apportioned between the states in which it does business and its nonbusiness income is allocated to its state of domicile. K.S.A. 79-3272. "Business income" is defined in K.S.A. 79-3271(a) as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" is "all income other than business income." K.S.A. 79-3271(e). The question we must answer is whether Kroger's interest expenses on the loans used to finance its defense of a hostile takeover are an apportionable business expense or allocable nonbusiness expense.

Both parties agree that only the transactional test applies to determine whether Kroger's expense during the audit period is a business or nonbusiness expense. BOTA found the interest expenses to be nonbusiness expenses by applying the transactional test adopted in *Western Natural Gas Co. v. McDonald*, 202 Kan. 98, 446 P.2d 781 (1968). The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. To be business income, the transaction and activity must have been in the regular course of the taxpayer's business operations. 202 Kan. at 100.

Kroger argues that the restructuring expense was an operational business expense to retain financial management of the corporation's assets, rather than an investment. For support, Kroger points out that the interest was deducted on its federal income tax return as a business expense and that the expense was also within the general rules for deductible business expenses set out in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352, 29 L. Ed. 2d 519, 91. S. Ct. 1893 (1971).

Kroger points out that it files income tax returns in 31 states, and none of those jurisdictions treat the expenses apportioned by Kroger as nonbusiness expenses. Kroger contends that classifying the interest expense as a nonbusiness expense violates the principles of the Multistate Tax Compact, including the promotion of uniformity and compatibility across jurisdictions and the avoidance of duplicative taxation. Kroger asserts that treating the interest expenses as nonbusiness expenses will cause it to suffer duplicative taxation.

KDR argues that Kansas does not conform to other jurisdictions in treating Kroger's interest expenses as a nonbusiness expense because at the time of the assessment Kansas was one of a few states that had rejected the functional test for defining business income. The functional test, rather than focusing on the particular transaction giving rise to the income as required by the transactional test, focuses on the utilization of the property in the business. *In re Tax Appeal of Chief Industries, Inc.*, 255 Kan. 640, 647, 875 P.2d 278 (1994). Under the functional test, gain from the sale of property is business income if the property was used in the taxpayer's business operations. 255 Kan. at 654.

We note that the 1996 Kansas Legislature amended the tax statutes to include the functional test. L. 1996, ch.264, § 1. In amending the statute, the Kansas Legislature recognized the non-uniformity resulting from excluding the functional test, amended the tax law to deal with the problem, and chose to limit the application of the functional test to tax years after December 31, 1995. K.S.A. 79-3271(a).

To qualify as an allowable deduction under 26 U.S.C. § 162(a) of the Internal Revenue Code, an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. The requisite showing that an expense is "necessary" is a minimally burdensome one. *PNC Bancorp, Inc. v. C.I.R.*, 212 F.3d 822, 828 (3d Cir. 2000) (citing *Lincoln Savings & Loan*, 403 U.S. at 352). Clearly, the test for allowable deductions under the Internal Revenue Code is broader than the transactional test for business income. To meet it, a taxpayer need show only that the expenditures were "appropriate and helpful." *Bancorp*, 212 F.3d at 828 n. 11.

KDR argues that the Internal Revenue Code does not apply. For support of its argument that expenses associated with transactions undertaken to defeat a hostile takeover attempt do not qualify as business transactions under the transactional test, KDR relies on *Robert Half Internat., Inc. v. Franchise Tax Bd.*, 66 Cal. App. 4th 1020, 78 Cal.Rptr.2d 453 (as modified on denial of rehearing [1998]); *Phillips Petroleum v. Dept. of Revenue*, 511 N.W.2d 608 (Iowa 1993) (as amended on denial of rehearing [1994]); *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn. 1998); *Union Carbide Corp. v. Huddleston*, 854

S.W.2d 87 (Tenn.1993). We note that California and Minnesota are members of the Multistate Tax Commission. Tennessee is an associate member and Iowa is a project member (Multistate Tax Commission, April 10, 2000).

In *Phillips*, the management of a petroleum corporation responded to a threatened hostile takeover by purchasing a substantial amount of its outstanding common stock. To retire the debt incurred for the purchase, the corporation sold gas and oil producing assets. The question was whether the income from the sale of those assets was apportionable. Applying the transactional test for business income, the *Phillips* court found that the income was nonbusiness income. The court based its holding on the unprecedented nature and enormity of the transaction that was "clearly a once-in-a-corporate-lifetime occurrence." *Phillips*, 511 N.W.2d at 611. The Iowa legislature promptly amended the Iowa tax statute to include the functional test. Iowa Code § 422.32(2) (1995). See *Polaroid Corp. v. Offerman*, 349 N.C. 290, 295, 507 S.E.2d 284 (1998), *cert. denied* 526 U.S. 1098 (1999).

In *Hercules*, a corporation domiciled in Delaware and conducting business in Minnesota, sold its stock in a corporation it helped create 4 years earlier, Himont, Inc. The sale resulted in net capital gain. Hercules reported the gain as nonapportionable income on its Minnesota corporate tax return. The Minnesota Commissioner of Revenue issued a notice of assessment, seeking payment of additional taxes based on the income from the sale. Hercules appealed. The Minnesota tax court concluded that the income was business income apportionable to Minnesota because Hercules held the stock as a means of furthering its trade or business. The Minnesota Supreme

Court reversed the tax court, concluding that the income was nonbusiness income and, therefore, not apportionable. *Hercules*, 575 N.W.2d at 113.

In reaching its conclusion, the Minnesota court framed the issue as whether the income was derived from the trade or business of Hercules. The court noted that Minnesota tax law provides that "intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business." 575 N.W.2d at 114-15. Applying the Minnesota statutory definition and prior related case law, the *Hercules* court discerned the boundary between business and nonbusiness income, noting:

> "Hercules' ownership and sale of Himont stock was not sufficiently linked to its day-to-day operations to make the Himont gain business income. Hercules carried the Himont stock on its books for more than four years as an investment, not as an asset. Moreover, it sold its Himont holdings only in direct response to Montedison's hostile takeover threat. We see no indication that Hercules wanted or needed the proceeds from the Himont gain to provide operating funds. . . . The record leads us to conclude that neither Hercules' holding of the Himont stock nor the gain realized from its sale was used in Hercules' day-to-day business operations. Therefore, we hold that the Himont gain is nonbusiness income and thus not apportionable to Minnesota." 575 N.W.2d at 115-16.

In *Union Carbide Corp.*, 854 S.W.2d 87, the taxpayer, Union Carbide, was a multistate, multinational corporation organized and incorporated under the laws of New

York, with its principle place of business and commercial domicile in Connecticut. Necessitated by financial difficulties stemming from the Bhopal, India, industrial accident, Union Carbide announced a restructuring program under which it planned to repurchase some of the outstanding shares of its common stock and divest itself of certain nonstrategic assets and businesses. Before the restructuring program was completed, Union Carbide became a target of a hostile tender offer by a competing chemical company. In response to the threatened hostile takeover, Union Carbide commenced an exchange offer of approximately $4.347 billion to its shareholders.

To raise the $4.347 billion, Union Carbide sold and liquidated seven distinct lines of business and borrowed $.71 billion. On its Tennessee tax return, Union Carbide reported the capital gains realized on the sale of the lines of business as nonbusiness earnings. The Tennessee Department of Revenue characterized the income as business earnings. The case was appealed to the Supreme Court of Tennessee.

The Tennessee court applied the transactional test for business income. In analyzing whether the gains from the disposition of assets were earnings arising from transactions and activity in the regular course of Union Carbide's business, the court inquired into the frequency and regularity of similar transactions, the former practices of the business, and Union Carbide's subsequent use of the income. 854 S.W.2d at 92. The Tennessee court concluded that although Union Carbide regularly acquired and disposed of assets, the capital gains from the 1986 divestiture were not "business earnings" arising out of the regular course of Union Carbide's business because it had

never before engaged in similar transactions of that magnitude. The court concluded the sale was nonbusiness income because the gains from the sales were not reinvested in Union Carbide's ongoing business operations. 854 S.W.2d at 93-94.

In *Robert Half*, 66 Cal. App. 4th 1020, the corporation's principal business was the development of real estate. The corporation spent $7.5 million to repurchase and cancel a warrant held by a third party. On its corporate franchise tax return, the corporation deducted the entire payment as a nonbusiness loss allocated to its state of domicile. The California trial court ruled that the corporation was not entitled to deduct the loss as a nonbusiness loss. On appeal, the parties agreed that the transaction did not qualify as a business loss under the transactional test.

After noting that the California statute defining business income includes both the transactional and functional tests, the California appellate court applied the functional test to determine whether the corporation's payment of $7.5 million to cancel the warrant was a business loss. The court found that the warrant which entitled the holder to purchase a substantial and perhaps controlling block of stock at a below-market price had an unsettling effect on the market for the corporation's shares. Since the existence of that possibility was an extraordinary event, the loss the corporation incurred to negate that possibility was an extraordinary event that fell outside its regular trade or business operations. The court held that under the circumstances the corporation's payment resulted in a nonbusiness loss. 66 Cal. App. 4th at 1028.

KDR urges this court to apply *Phillips, Hercules, Union Carbide,* and *Robert Half* and find that Kroger's borrowing to defend against a hostile takeover was an extraordinary event that occurred in response to unusual circumstances and, therefore, expenses associated with the borrowing are nonbusiness expenses allocable to Kroger's state of domicile and not apportionable to Kansas.

Kroger attempts to distinguish those cases by pointing out that the cases cited concerned income or losses resulting from taxable events, such as the acquisition or sale of property. Kroger asserts that its borrowing resulted in an interest expense, not a taxable transaction. Kroger characterizes the payment of interest expense as an operational expense – a function of its ongoing business operations, not extraordinary in nature. Furthermore, Kroger argues that KDR has unilaterally disallowed all Kroger's interest expenses, without regard to whether the expenses were incurred as part of the 1988 restructuring.

To support its argument, Kroger characterizes the payment of interest as an ongoing series of transactions, not an isolated event such as the sale of assets, *i.e.*, its borrowing and the interest expense constituted financial management and ordinary and necessary business expenses. KDR, on the other hand, states that we must consider the underlying transaction which resulted in the interest expense – the borrowing undertaken to defend against a hostile takeover – and that, based on our statutes and the case law it cited, such transactions are extraordinary and outside the ordinary course of business.

At the time of the assessment, the transactional test applied to determine whether an expense during the audit period was a business or nonbusiness expense. Resolution of the question can best be had by the definition of business income. As noted previously, business income is defined in K.S.A. 79-3271(a) as "income *arising from* transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (Emphasis added.)

The inquiry is, did the transaction give rise to business income? Analyzing expenses similarly to income, to be a business expense, the transaction must be in the regular and ordinary course of business. The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. BOTA is correct that under the transactional test, the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense.

Affirmed.

APPENDIX B

SUPREME COURT OF KANSAS

Office of the Clerk

Kansas Judicial Center

301 SW 10th Avenue

Topeka, Kansas 66612-1507

December 29, 2000

re: IN THE MATTER OF THE APPEAL OF THE KROGER CO., FROM AN ORDER OF THE DIVISION OF TAXATION ON ASSESSMENT OF CORPORATE INCOME TAX
Supreme Court Case No. 83927

Enclosed please find a corrected opinion in the above matter replacing the "modified" published opinion mailed December 21, 2000.

The correction is as follows:

Page Two, Paragraph 3, Line 2 - the date of the opinion has been changed back to November 3, 2000, rather than December 21, 2000.

Please feel free to contact our office if you have any questions.

Sincerely,

/s/ Kathie L. Garman
Kathie L. Garman
Deputy Clerk

encl.

APPENDIX C

Modified Opinion

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 83,927

In the Matter of the Appeal of
The Kroger Co., from an Order of the
Division of Taxation
on Assessment of Corporate Income Tax.

SYLLABUS BY THE COURT

1.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act.

2.

The Multistate Tax Compact, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4).

3.

K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year.

4.

The controlling factor in the transactional test for the determination of business income is the nature of the

particular transaction giving rise to the income. To be business income, the transaction and activity must have been in the regular course of the taxpayer's business operations.

5.

Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review.

Appeal from the Board of Tax Appeals. Opinion modified December 21, 2000. Affirmed.

John H. Wachter, of Wright, Henson, Somers, Sebelius, Clark & Baker, L.L.P., of Topeka, argued the cause and *Charles N. Henson*, of the same firm, was with him on the brief for appellant The Kroger Co.

James Bartle, of Kansas Department of Revenue, argued the cause and was on the brief for appellee.

The opinion of the court was delivered by

LOCKETT, J: Multistate taxpayer appeals the Board of Tax Appeals' (BOTA) order disallowing as an apportionable business expense an interest expense incurred to fight a hostile takeover. BOTA classified the expense as a nonbusiness expense, which was allocated to the taxpayer's state of commercial domicile. Taxpayer appealed, claiming its interest expense was a business expense, apportionable to Kansas.

The taxpayer, The Kroger Co. (Kroger), and the Department of Revenue (KDR) stipulated that late in 1988, Kroger, an Ohio corporation operating retail food and grocery stores in Kansas and numerous other states,

was the target of hostile takeover attempts by two separate groups. In response to these threats, Kroger's board of directors determined it was in the best interest of the company and its shareholders to defend against the hostile takeover. To avoid the takeover, Kroger declared a special dividend to its shareholders. To finance the special dividend, Kroger borrowed $4.1 billion. The borrowing of $4.1 billion required Kroger to pay large amounts of interest for the tax years ending December 30, 1989, through January 2, 1993 (the audit period). The interest expenses were declared by Kroger pursuant to the Internal Revenue Code, 26 U.S.C. § 162 (1994), as ordinary and necessary business expenses and deducted by Kroger on its federal income tax return.

KDR determined that Kroger's interest cost associated with the 1988 restructuring was a nonbusiness expense and not apportionable to Kansas. As a result, KDR assessed Kroger additional Kansas income tax of $5,145,161, with interest of $4,095,734 and a penalty of $1,286,294, for a total assessment of $10,527,189. KDR's assessment was based on its determination that Kroger's claimed interest expense resulting from borrowing to deter a hostile takeover was not an apportionable business expense arising from an activity in the regular course of Kroger's business.

The Kansas Income Tax Act, K.S.A. 79-3201 *et seq.*, provides that the Act shall be administered by the Secretary of Revenue or the Secretary's designee for the purpose of ascertaining the correctness of any return. See K.S.A. 79-3233. Kroger protested KDR's assessment by filing a request for hearing with the Secretary of KDR. The Secretary issued a written determination, finding

that Kroger's interest expense associated with defending against the hostile takeover bid was not a business expense incurred in the regular course of Kroger's operations; therefore, the interest expense of Kroger's $4.1 billion debt was a nonbusiness expense.

Kroger appealed the Secretary's determination to BOTA. BOTA found that the regular course of Kroger's business is the retail sale of groceries and that fending off a hostile takeover was not an activity associated with the selling of groceries. By a 4 to 1 majority, BOTA concluded that the interest expense was nonbusiness in nature and should be allocated to Kroger's state of domicile. BOTA later denied Kroger's request for reconsideration. Kroger appealed to the Court of Appeals, and its motion for transfer to the Supreme Court was subsequently granted. Our jurisdiction is pursuant to K.S.A. 20-3017.

Kroger seeks review under the Kansas Act for Judicial Review and Civil Enforcement of Agency Actions (KJRA), K.S.A. 77-601 *et seq.*, claiming BOTA erroneously interpreted the Kansas Income Tax Act or misapplied the law. See K.S.A. 77-621(c)(4). The KJRA provides that the party challenging BOTA's action has the burden to prove that the action by BOTA was erroneous. K.S.A. 77-621(a). See *In re Tax Appeal of Scholastic Book Clubs, Inc.*, 260 Kan. 528, 536, 920 P.2d 947 (1996).

Under the doctrine of operative construction, the interpretation of a statute by an agency charged with its enforcement is entitled to judicial deference. *Blue v. McBride*, 252 Kan. 894, Syl. ¶ 7, 850 P.2d 852 (1993). Despite the deference given to an agency's interpretation of the law it administers, if the court finds that the

administrative body's interpretation is erroneous as a matter of law, the court will take corrective steps. *In re Tax Appeal of Univ. of Kan. School of Medicine*, 266 Kan. 737, 749, 973 P.2d 176 (1999). Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review. *Wasson v. United Dominion Industries*, 266 Kan. 1012, 1018, 974 P.2d 578 (1999).

Statutory Construction of Tax Laws

First, Kroger contends that KDR does not have the statutory authority to disallow the interest expense as a business expense. Kroger notes that the principles and rules of statutory construction of tax laws place the burden on KDR to cite to clear and unequivocal terms within the tax statutes. The principles have been established by the court because of the general nature of the imposition and collection of taxes. Although courts have uniformly recognized that the power to levy taxes is inherent in the power to govern, the exercise of that power is dependent on the existence of legislation creating the tax. Nothing is taxable unless clearly within a taxing statute. *Robbins-Leavenworth Floor Covering, Inc. v. Leavenworth Nat'l Bank & Trust Co.*, 229 Kan. 511, 512, 625 P.2d 494 (1981). Tax laws are statutory and do not exist apart from the statute and, as such, they must be strictly construed. *American Home Life Ins. Co. v. Board of Shawnee County Comm'rs.*, 22 Kan. App. 2d 18, 23, 913 P.2d 1211, *rev. denied* 258 Kan. 857 (1995). Where there is a reasonable doubt as to the meaning of a taxing statute, the statute will be construed most favorably to the taxpayer. *Fleming Co. v. McDonald*, 212 Kan. 11, Syl. ¶ 1, 509 P.2d 1162 (1973). KDR argues

that K.S.A. 79-3272 and K.S.A. 79-3274 encompass expenses as a component of net income.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), K.S.A. 79-3271 *et seq.* Neither the Kansas statutes nor the regulations of the KDR define a "nonbusiness expense." However, K.S.A. 79-3272 provides that "net" business and nonbusiness income shall be allocated and apportioned according to UDITPA. The Multistate Tax Compact, K.S.A. 79-4301 *et seq.*, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4). Furthermore, K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year. Expenses, therefore, are a factor in the derivation of net income, and a statutory basis, implicit in the determination of "net" income, exists for making a determination regarding whether a multistate corporation may apportion certain expenses to the various states where it does business. Kroger apportioned part of its interest cost to its Kansas income based upon the UDITPA, the Internal Revenue Code, and its interpretation of the relevant Kansas tax statutes.

Classification of Interest Expense

The borrowing of $4.1 billion to defeat the hostile takeover required Kroger to pay large amounts of interest

during the audit period. The calculation of the taxes owed to Kansas by a corporation begins with the corporation's federal taxable income; that income is then subject to modification as specified in K.S.A. 79-32,138. UDITPA provides that a corporation's business income is apportioned between the states in which it does business and its nonbusiness income is allocated to its state of domicile. K.S.A. 79-3272. "Business income" is defined in K.S.A. 79-3271(a) as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" is "all income other than business income." K.S.A. 79-3271(e). The question we must answer is whether Kroger's interest expenses on the loans used to finance its defense of a hostile takeover are an apportionable business expense or allocable nonbusiness expense.

Both parties agree that only the transactional test applies to determine whether Kroger's expense during the audit period is a business or nonbusiness expense. BOTA found the interest expenses to be nonbusiness expenses by applying the transactional test adopted in *Western Natural Gas Co. v. McDonald*, 202 Kan. 98, 446 P.2d 781 (1968). The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. To be business income, the transaction and activity must have been in the regular course of the taxpayer's business operations. 202 Kan. at 100.

Kroger argues that the restructuring expense was an operational business expense to retain financial management of the corporation's assets, rather than an investment. For support, Kroger points out that the interest was deducted on its federal income tax return as a business expense and that the expense was also within the general rules for deductible business expenses set out in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352, 29 L. Ed. 2d 519, 91. S. Ct. 1893 (1971).

Kroger points out that it files income tax returns in 31 states, and none of those jurisdictions treat the expenses apportioned by Kroger as nonbusiness expenses. Kroger contends that classifying the interest expense as a nonbusiness expense violates the principles of the Multistate Tax Compact, including the promotion of uniformity and compatibility across jurisdictions and the avoidance of duplicative taxation. Kroger asserts that treating the interest expenses as nonbusiness expenses will cause it to suffer duplicative taxation.

KDR argues that Kansas does not conform to other jurisdictions in treating Kroger's interest expenses as a nonbusiness expense because at the time of the assessment Kansas was one of a few states that had rejected the functional test for defining business income. The functional test, rather than focusing on the particular transaction giving rise to the income as required by the transactional test, focuses on the utilization of the property in the business. *In re Tax Appeal of Chief Industries, Inc.*, 255 Kan. 640, 647, 875 P.2d 278 (1994). Under the functional test, gain from the sale of property is business income if the property was used in the taxpayer's business operations. 255 Kan. at 654.

We note that the 1996 Kansas Legislature amended the tax statutes to include the functional test. L.1996, ch.264, § 1. In amending the statute, the Kansas Legislature recognized the non-uniformity resulting from excluding the functional test, amended the tax law to deal with the problem, and chose to limit the application of the functional test to tax years after December 31, 1995. K.S.A. 79-3271(a).

To qualify as an allowable deduction under 26 U.S.C. § 162(a) of the Internal Revenue Code, an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. The requisite showing that an expense is "necessary" is a minimally burdensome one. *PNC Bancorp, Inc. v. C.I.R.*, 212 F.3d 822, 828 (3d Cir. 2000) (citing *Lincoln Savings & Loan*, 403 U.S. at 352). Clearly, the test for allowable deductions under the Internal Revenue Code is broader than the transactional test for business income. To meet it, a taxpayer need show only that the expenditures were "appropriate and helpful." *Bancorp*, 212 F.3d at 828 n.11.

KDR argues that the Internal Revenue Code does not apply. For support of its argument that expenses associated with transactions undertaken to defeat a hostile takeover attempt do not qualify as business transactions under the transactional test, KDR relies on *Robert Half Internat., Inc. v. Franchise Tax Bd.*, 66 Cal. App. 4th 1020, 78 Cal.Rptr.2d 453 (as modified on denial of rehearing [1998]); *Phillips Petroleum v. Dept. of Revenue*, 511 N.W.2d 608 (Iowa 1993) (as amended on denial of rehearing [1994]); *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn.1998); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d

87 (Tenn.1993). We note that California and Minnesota are members of the Multistate Tax Commission. Tennessee is an associate member and Iowa is a project member (Multistate Tax Commission, April 10, 2000).

In *Phillips*, the management of a petroleum corporation responded to a threatened hostile takeover by purchasing a substantial amount of its outstanding common stock. To retire the debt incurred for the purchase, the corporation sold gas and oil producing assets. The question was whether the income from the sale of those assets was apportionable. Applying the transactional test for business income, the *Phillips* court found that the income was nonbusiness income. The court based its holding on the unprecedented nature and enormity of the transaction that was "clearly a once-in-a-corporate-lifetime occurrence." *Phillips*, 511 N.W.2d at 611. The Iowa legislature promptly amended the Iowa tax statute to include the functional test. Iowa Code § 422.32(2) (1995). See *Polaroid Corp. v. Offerman*, 349 N.C. 290, 295, 507 S.E.2d 284 (1998), *cert. denied* 526 U.S. 1098 (1999).

In *Hercules*, a corporation domiciled in Delaware and conducting business in Minnesota, sold its stock in a corporation it helped create 4 years earlier, Himont, Inc. The sale resulted in net capital gain. Hercules reported the gain as nonapportionable income on its Minnesota corporate tax return. The Minnesota Commissioner of Revenue issued a notice of assessment, seeking payment of additional taxes based on the income from the sale. Hercules appealed. The Minnesota tax court concluded that the income was business income apportionable to Minnesota because Hercules held the stock as a means of furthering its trade or business. The Minnesota Supreme

Court reversed the tax court, concluding that the income was nonbusiness income and, therefore, not apportionable. *Hercules*, 575 N.W.2d at 113.

In reaching its conclusion, the Minnesota court framed the issue as whether the income was derived from the trade or business of Hercules. The court noted that Minnesota tax law provides that "intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business." 575 N.W.2d at 114-15. Applying the Minnesota statutory definition and prior related case law, the *Hercules* court discerned the boundary between business and nonbusiness income, noting:

> "Hercules' ownership and sale of Himont stock was not sufficiently linked to its day-to-day operations to make the Himont gain business income. Hercules carried the Himont stock on its books for more than four years as an investment, not as an asset. Moreover, it sold its Himont holdings only in direct response to Montedison's hostile takeover threat. We see no indication that Hercules wanted or needed the proceeds from the Himont gain to provide operating funds. . . . The record leads us to conclude that neither Hercules' holding of the Himont stock nor the gain realized from its sale was used in Hercules' day-to-day business operations. Therefore, we hold that the Himont gain is nonbusiness income and thus not apportionable to Minnesota." 575 N.W.2d at 115-16.

In *Union Carbide Corp.*, 854 S.W.2d 87, the taxpayer, Union Carbide, was a multistate, multinational corporation organized and incorporated under the laws of New

York, with its principle place of business and commercial domicile in Connecticut. Necessitated by financial difficulties stemming from the Bhopal, India, industrial accident, Union Carbide announced a restructuring program under which it planned to repurchase some of the outstanding shares of its common stock and divest itself of certain nonstrategic assets and businesses. Before the restructuring program was completed, Union Carbide became a target of a hostile tender offer by a competing chemical company. In response to the threatened hostile takeover, Union Carbide commenced an exchange offer of approximately $4.347 billion to its shareholders.

To raise the $4.347 billion, Union Carbide sold and liquidated seven distinct lines of business and borrowed $.71 billion. On its Tennessee tax return, Union Carbide reported the capital gains realized on the sale of the lines of business as nonbusiness earnings. The Tennessee Department of Revenue characterized the income as business earnings. The case was appealed to the Supreme Court of Tennessee.

The Tennessee court applied the transactional test for business income. In analyzing whether the gains from the disposition of assets were earnings arising from transactions and activity in the regular course of Union Carbide's business, the court inquired into the frequency and regularity of similar transactions, the former practices of the business, and Union Carbide's subsequent use of the income. 854 S.W.2d at 92. The Tennessee court concluded that although Union Carbide regularly acquired and disposed of assets, the capital gains from the 1986 divestiture were not "business earnings" arising out of the regular course of Union Carbide's business because it had

never before engaged in similar transactions of that magnitude. The court concluded the sale was nonbusiness income because the gains from the sales were not reinvested in Union Carbide's ongoing business operations. 854 S.W.2d at 93-94.

In *Robert Half*, 66 Cal. App. 4th 1020, the corporation's principal business was the development of real estate. The corporation spent $7.5 million to repurchase and cancel a warrant held by a third party. On its corporate franchise tax return, the corporation deducted the entire payment as a nonbusiness loss allocated to its state of domicile. The California trial court ruled that the corporation was not entitled to deduct the loss as a nonbusiness loss. On appeal, the parties agreed that the transaction did not qualify as a business loss under the transactional test.

After noting that the California statute defining business income includes both the transactional and functional tests, the California appellate court applied the functional test to determine whether the corporation's payment of $7.5 million to cancel the warrant was a business loss. The court found that the warrant which entitled the holder to purchase a substantial and perhaps controlling block of stock at a below-market price had an unsettling effect on the market for the corporation's shares. Since the existence of that possibility was an extraordinary event, the loss the corporation incurred to negate that possibility was an extraordinary event that fell outside its regular trade or business operations. The court held that under the circumstances the corporation's payment resulted in a nonbusiness loss. 66 Cal. App. 4th at 1028.

KDR urges this court to apply *Phillips*, *Hercules*, *Union Carbide*, and *Robert Half* and find that Kroger's borrowing to defend against a hostile takeover was an extraordinary event that occurred in response to unusual circumstances and, therefore, expenses associated with the borrowing are nonbusiness expenses allocable to Kroger's state of domicile and not apportionable to Kansas.

Kroger attempts to distinguish those cases by pointing out that the cases cited concerned income or losses resulting from taxable events, such as the acquisition or sale of property. Kroger asserts that its borrowing resulted in an interest expense, not a taxable transaction. Kroger characterizes the payment of interest expense as an operational expense – a function of its ongoing business operations, not extraordinary in nature. Furthermore, Kroger argues that KDR has unilaterally disallowed all Kroger's interest expenses, without regard to whether the expenses were incurred as part of the 1988 restructuring.

To support its argument, Kroger characterizes the payment of interest as an ongoing series of transactions, not an isolated event such as the sale of assets, *i.e.*, its borrowing and the interest expense constituted financial management and ordinary and necessary business expenses. KDR, on the other hand, states that we must consider the underlying transaction which resulted in the interest expense – the borrowing undertaken to defend against a hostile takeover – and that, based on our statutes and the case law it cited, such transactions are extraordinary and outside the ordinary course of business.

At the time of the assessment, the transactional test applied to determine whether an expense during the audit period was a business or nonbusiness expense. Resolution of the question can best be had by the definition of business income. As noted previously, business income is defined in K.S.A. 79-3271(a) as "income *arising from* transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (Emphasis added.)

The inquiry is, did the transaction give rise to business income? Analyzing expenses similarly to income, to be a business expense, the transaction must be in the regular and ordinary course of business. The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. BOTA is correct that under the transactional test, the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense.

Affirmed.

APPENDIX D

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 83,927

In the Matter of the Appeal of The Kroger Co., from an Order of the Division of Taxation on Assessment of Corporate Income Tax

ORDER CORRECTING OPINION

The court's opinion filed on November 3, 2000, is hereby corrected to read as follows:

Modification to Page 2 of the original opinion:

Delete Syllabus ¶ 4.

Modification to Page 4 of the original opinion:

In the first sentence of the first full paragraph on the page, delete "1998" and insert "1988."

Modification to Page 8 of the original opinion:

In the first sentence of the final partial paragraph, delete "expense" before "restructuring" and insert "expense" after "restructuring."

Modification to Page 10 of the original opinion:

In the last sentence of the first paragraph, insert a "3" before the "1" after "December," changing the date to December 31.

Modification to Page 11 of the original opinion:

In the third sentence of the first full paragraph, delete "a" and insert "the" after "Applying."

BY ORDER OF THE COURT on this 21 day of December, 2000.

FOR THE COURT

/s/ Tyler C. Lockett
TYLER C. LOCKETT
Justice

APPENDIX E

IN THE SUPREME COURT OF THE STATE OF KANSAS

No. 83,927

In the Matter of the Appeal of
The Kroger Co., from an Order of the
Division of Taxation
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SYLLABUS BY THE COURT

1.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act.

2.

The Multistate Tax Compact, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4).

3.

K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year.

4.

In Kansas, before December 1, 1995, the transactional test for the determination of business income was the

exclusive test to determine whether an expense during the audit period was a business or nonbusiness expense.

5.

The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. To be business income, the transaction and activity must have been in the regular course of the taxpayer's business operations.

6.

Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review.

Appeal from the Board of Tax Appeals. Opinion filed November 3, 2000. Affirmed.

John H. Wachter, of Wright, Henson, Somers, Sebelius, Clark & Baker, L.L.P., of Topeka, argued the cause and *Charles N. Henson*, of the same firm, was with him on the brief for appellant The Kroger Co.

James Bartle, of Kansas Department of Revenue, argued the cause and was on the brief for appellee.

The opinion of the court was delivered by

LOCKETT, J: Multistate taxpayer appeals the Board of Tax Appeals' (BOTA) order disallowing as an apportionable business expense an interest expense incurred to fight a hostile takeover. BOTA classified the expense as a nonbusiness expense, which was allocated to the taxpayer's state of commercial domicile. Taxpayer appealed,

claiming its interest expense was a business expense, apportionable to Kansas.

The taxpayer, The Kroger Co. (Kroger), and the Department of Revenue (KDR) stipulated that late in 1988, Kroger, an Ohio corporation operating retail food and grocery stores in Kansas and numerous other states, was the target of hostile takeover attempts by two separate groups. In response to these threats, Kroger's board of directors determined it was in the best interest of the company and its shareholders to defend against the hostile takeover. To avoid the takeover, Kroger declared a special dividend to its shareholders. To finance the special dividend, Kroger borrowed $4.1 billion. The borrowing of $4.1 billion required Kroger to pay large amounts of interest for the tax years ending December 30, 1989, through January 2, 1993 (the audit period). The interest expenses were declared by Kroger pursuant to the Internal Revenue Code, 26 U.S.C. § 162 (1994), as ordinary and necessary business expenses and deducted by Kroger on its federal income tax return.

KDR determined that Kroger's interest cost associated with the 1998 restructuring was a nonbusiness expense and not apportionable to Kansas. As a result, KDR assessed Kroger additional Kansas income tax of $5,145,161, with interest of $4,095,734 and a penalty of $1,286,294, for a total assessment of $10,527,189. KDR's assessment was based on its determination that Kroger's claimed interest expense resulting from borrowing to deter a hostile takeover was not an apportionable business expense arising from an activity in the regular course of Kroger's business.

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Under the doctrine of operative construction, the interpretation of a statute by an agency charged with its enforcement is entitled to judicial deference. *Blue v. McBride*, 252 Kan. 894, Syl. ¶ 7, 850 P.2d 852 (1993). Despite the deference given to an agency's interpretation of the law it administers, if the court finds that the administrative body's interpretation is erroneous as a matter of law, the court will take corrective steps. *In re Tax Appeal of Univ. of Kan. School of Medicine*, 266 Kan. 737, 749, 973 P.2d 176 (1999). Whether an agency has erroneously interpreted a statute is a question over which an appellate court has unlimited review. *Wasson v. United Dominion Industries*, 266 Kan. 1012, 1018, 974 P.2d 578 (1999).

Statutory Construction of Tax Laws

First, Kroger contends that KDR does not have the statutory authority to disallow the interest expense as a business expense. Kroger notes that the principles and rules of statutory construction of tax laws place the burden on KDR to cite to clear and unequivocal terms within the tax statutes. The principles have been established by the court because of the general nature of the imposition and collection of taxes. Although courts have uniformly recognized that the power to levy taxes is inherent in the power to govern, the exercise of that power is dependent on the existence of legislation creating the tax. Nothing is taxable unless clearly within a taxing statute. *Robbins-Leavenworth Floor Covering, Inc. v. Leavenworth Nat'l Bank & Trust Co.*, 229 Kan. 511, 512, 625 P.2d 494 (1981). Tax laws are statutory and do not exist apart from the statute and, as such, they must be strictly construed. *American*

Home Life Ins. Co. v. Board of Shawnee County Comm'rs., 22 Kan. App. 2d 18, 23, 913 P.2d 1211, *rev. denied* 258 Kan. 857 (1995). Where there is a reasonable doubt as to the meaning of a taxing statute, the statute will be construed most favorably to the taxpayer. *Fleming Co. v. McDonald*, 212 Kan. 11, Syl. ¶ 1, 509 P.2d 1162 (1973). KDR argues that K.S.A. 79-3272 and K.S.A. 79-3274 encompass expenses as a component of net income.

Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), K.S.A. 79-3271 *et seq.* Neither the Kansas statutes nor the regulations of the KDR define a "nonbusiness expense." However, K.S.A. 79-3272 provides that "net" business and nonbusiness income shall be allocated and apportioned according to UDITPA. The Multistate Tax Compact, K.S.A. 79-4301 *et seq.*, adopted in Kansas in 1967, defines "income tax" as a tax imposed on or measured by an amount arrived at by deducting expenses from gross income. K.S.A. 79-4301, Art. II(4). Furthermore, K.S.A. 79-3274 provides that allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year. Expenses, therefore, are a factor in the derivation of net income, and a statutory basis, implicit in the determination of "net" income, exists for making a determination regarding whether a multistate corporation may apportion certain expenses to the various states where it does business. Kroger apportioned part of its interest cost to its Kansas income based upon the

UDITPA, the Internal Revenue Code, and its interpretation of the relevant Kansas tax statutes.

Classification of Interest Expense

The borrowing of $4.1 billion to defeat the hostile takeover required Kroger to pay large amounts of interest during the audit period. The calculation of the taxes owed to Kansas by a corporation begins with the corporation's federal taxable income; that income is then subject to modification as specified in K.S.A. 79-32,138. UDITPA provides that a corporation's business income is apportioned between the states in which it does business and its nonbusiness income is allocated to its state of domicile. K.S.A. 79-3272. "Business income" is defined in K.S.A. 79-3271(a) as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Nonbusiness income" is "all income other than business income." K.S.A. 79-3271(e). The question we must answer is whether Kroger's interest expenses on the loans used to finance its defense of a hostile takeover are an apportionable business expense or allocable nonbusiness expense.

Both parties agree that only the transactional test applies to determine whether Kroger's expense during the audit period is a business or nonbusiness expense. BOTA found the interest expenses to be nonbusiness expenses by applying the transactional test adopted in

Western Natural Gas Co. v. McDonald, 202 Kan. 98, 446 P.2d 781 (1968). The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. To be business income, the transaction and activity must have been in the regular course of the taxpayer's business operations. 202 Kan. at 100.

Kroger argues that the expense restructuring was an operational business expense to retain financial management of the corporation's assets, rather than an investment. For support, Kroger points out that the interest was deducted on its federal income tax return as a business expense and that the expense was also within the general rules for deductible business expenses set out in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352, 29 L. Ed. 2d 519, 91. S. Ct. 1893 (1971).

Kroger points out that it files income tax returns in 31 states, and none of those jurisdictions treat the expenses apportioned by Kroger as nonbusiness expenses. Kroger contends that classifying the interest expense as a nonbusiness expense violates the principles of the Multistate Tax Compact, including the promotion of uniformity and compatibility across jurisdictions and the avoidance of duplicative taxation. Kroger asserts that treating the interest expenses as nonbusiness expenses will cause it to suffer duplicative taxation.

KDR argues that Kansas does not conform to other jurisdictions in treating Kroger's interest expenses as a nonbusiness expense because at the time of the assessment Kansas was one of a few states that had rejected the

functional test for defining business income. The functional test, rather than focusing on the particular transaction giving rise to the income as required by the transactional test, focuses on the utilization of the property in the business. *In re Tax Appeal of Chief Industries, Inc.*, 255 Kan. 640, 647, 875 P.2d 278 (1994). Under the functional test, gain from the sale of property is business income if the property was used in the taxpayer's business operations. 255 Kan. at 654.

We note that the 1996 Kansas Legislature amended the tax statutes to include the functional test. L.1996, ch.264, § 1. In amending the statute, the Kansas Legislature recognized the non-uniformity resulting from excluding the functional test, amended the tax law to deal with the problem, and chose to limit the application of the functional test to tax years after December 1, 1995. K.S.A. 79-3271(a).

To qualify as an allowable deduction under 26 U.S.C. § 162(a) of the Internal Revenue Code, an item must (1) be paid or incurred during the taxable year, (2) be for carrying on any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. The requisite showing that an expense is "necessary" is a minimally burdensome one. *PNC Bancorp, Inc. v. C.I.R.*, 212 F.3d 822, 828 (3d Cir. 2000) (citing *Lincoln Savings & Loan*, 403 U.S. at 352). Clearly, the test for allowable deductions under the Internal Revenue Code is broader than the transactional test for business income. To meet it, a taxpayer need show only that the expenditures were "appropriate and helpful." *Bancorp*, 212 F.3d at 828 n. 11.

KDR argues that the Internal Revenue Code does not apply. For support of its argument that expenses associated with transactions undertaken to defeat a hostile takeover attempt do not qualify as business transactions under the transactional test, KDR relies on *Robert Half Internat., Inc. v. Franchise Tax Bd.*, 66 Cal. App. 4th 1020, 78 Cal.Rptr.2d 453 (as modified on denial of rehearing [1998]); *Phillips Petroleum v. Dept. of Revenue*, 511 N.W.2d 608 (Iowa 1993) (as amended on denial of rehearing [1994]); *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn.1998); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn.1993). We note that California and Minnesota are members of the Multistate Tax Commission. Tennessee is an associate member and Iowa is a project member (Multistate Tax Commission, April 10, 2000).

In *Phillips*, the management of a petroleum corporation responded to a threatened hostile takeover by purchasing a substantial amount of its outstanding common stock. To retire the debt incurred for the purchase, the corporation sold gas and oil producing assets. The question was whether the income from the sale of those assets was apportionable. Applying a transactional test for business income, the *Phillips* court found that the income was nonbusiness income. The court based its holding on the unprecedented nature and enormity of the transaction that was "clearly a once-in-a-corporate-lifetime occurrence." *Phillips*, 511 N.W.2d at 611. The Iowa legislature promptly amended the Iowa tax statute to include the functional test. Iowa Code § 422.32(2) (1995). See *Polaroid Corp. v. Offerman*, 349 N.C. 290, 295, 507 S.E.2d 284 (1998), *cert. denied* 526 U.S. 1098 (1999).

In *Hercules*, a corporation domiciled in Delaware and conducting business in Minnesota, sold its stock in a corporation it helped create 4 years earlier, Himont, Inc. The sale resulted in net capital gain. Hercules reported the gain as nonapportionable income on its Minnesota corporate tax return. The Minnesota Commissioner of Revenue issued a notice of assessment, seeking payment of additional taxes based on the income from the sale. Hercules appealed. The Minnesota tax court concluded that the income was business income apportionable to Minnesota because Hercules held the stock as a means of furthering its trade or business. The Minnesota Supreme Court reversed the tax court, concluding that the income was nonbusiness income and, therefore, not apportionable. *Hercules*, 575 N.W.2d at 113.

In reaching its conclusion, the Minnesota court framed the issue as whether the income was derived from the trade or business of Hercules. The court noted that Minnesota tax law provides that "intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business." 575 N.W.2d at 114-15. Applying the Minnesota statutory definition and prior related case law, the *Hercules* court discerned the boundary between business and nonbusiness income, noting:

> "Hercules' ownership and sale of Himont stock was not sufficiently linked to its day-to-day operations to make the Himont gain business income. Hercules carried the Himont stock on its books for more than four years as an investment, not as an asset. Moreover, it sold its Himont holdings only in direct response to Montedison's hostile takeover threat. We see no

> indication that Hercules wanted or needed the proceeds from the Himont gain to provide operating funds. . . . The record leads us to conclude that neither Hercules' holding of the Himont stock nor the gain realized from its sale was used in Hercules' day-to-day business operations. Therefore, we hold that the Himont gain is nonbusiness income and thus not apportionable to Minnesota." 575 N.W.2d at 115-16.

In *Union Carbide Corp.*, 854 S.W.2d 87, the taxpayer, Union Carbide, was a multistate, multinational corporation organized and incorporated under the laws of New York, with its principle place of business and commercial domicile in Connecticut. Necessitated by financial difficulties stemming from the Bhopal, India, industrial accident, Union Carbide announced a restructuring program under which it planned to repurchase some of the outstanding shares of its common stock and divest itself of certain nonstrategic assets and businesses. Before the restructuring program was completed, Union Carbide became a target of a hostile tender offer by a competing chemical company. In response to the threatened hostile takeover, Union Carbide commenced an exchange offer of approximately $4.347 billion to its shareholders.

To raise the $4.347 billion, Union Carbide sold and liquidated seven distinct lines of business and borrowed $.71 billion. On its Tennessee tax return, Union Carbide reported the capital gains realized on the sale of the lines of business as nonbusiness earnings. The Tennessee Department of Revenue characterized the income as business earnings. The case was appealed to the Supreme Court of Tennessee.

The Tennessee court applied the transactional test for business income. In analyzing whether the gains from the disposition of assets were earnings arising from transactions and activity in the regular course of Union Carbide's business, the court inquired into the frequency and regularity of similar transactions, the former practices of the business, and Union Carbide's subsequent use of the income. 854 S.W.2d at 92. The Tennessee court concluded that although Union Carbide regularly acquired and disposed of assets, the capital gains from the 1986 divestiture were not "business earnings" arising out of the regular course of Union Carbide's business because it had never before engaged in similar transactions of that magnitude. The court concluded the sale was nonbusiness income because the gains from the sales were not reinvested in Union Carbide's ongoing business operations. 854 S.W.2d at 93-94.

In *Robert Half*, 66 Cal. App. 4th 1020, the corporation's principal business was the development of real estate. The corporation spent $7.5 million to repurchase and cancel a warrant held by a third party. On its corporate franchise tax return, the corporation deducted the entire payment as a nonbusiness loss allocated to its state of domicile. The California trial court ruled that the corporation was not entitled to deduct the loss as a nonbusiness loss. On appeal, the parties agreed that the transaction did not qualify as a business loss under the transactional test.

After noting that the California statute defining business income includes both the transactional and functional tests, the California appellate court applied the functional test to determine whether the corporation's

payment of $7.5 million to cancel the warrant was a business loss. The court found that the warrant which entitled the holder to purchase a substantial and perhaps controlling block of stock at a below-market price had an unsettling effect on the market for the corporation's shares. Since the existence of that possibility was an extraordinary event, the loss the corporation incurred to negate that possibility was an extraordinary event that fell outside its regular trade or business operations. The court held that under the circumstances the corporation's payment resulted in a nonbusiness loss. 66 Cal. App. 4th at 1028.

KDR urges this court to apply *Phillips, Hercules, Union Carbide,* and *Robert Half* and find that Kroger's borrowing to defend against a hostile takeover was an extraordinary event that occurred in response to unusual circumstances and, therefore, expenses associated with the borrowing are nonbusiness expenses allocable to Kroger's state of domicile and not apportionable to Kansas.

Kroger attempts to distinguish those cases by pointing out that the cases cited concerned income or losses resulting from taxable events, such as the acquisition or sale of property. Kroger asserts that its borrowing resulted in an interest expense, not a taxable transaction. Kroger characterizes the payment of interest expense as an operational expense – a function of its ongoing business operations, not extraordinary in nature. Furthermore, Kroger argues that KDR has unilaterally disallowed all Kroger's interest expenses, without regard to whether the expenses were incurred as part of the 1988 restructuring.

To support its argument, Kroger characterizes the payment of interest as an ongoing series of transactions, not an isolated event such as the sale of assets, *i.e.*, its borrowing and the interest expense constituted financial management and ordinary and necessary business expenses. KDR, on the other hand, states that we must consider the underlying transaction which resulted in the interest expense – the borrowing undertaken to defend against a hostile takeover – and that, based on our statutes and the case law it cited, such transactions are extraordinary and outside the ordinary course of business.

At the time of the assessment, the transactional test applied to determine whether an expense during the audit period was a business or nonbusiness expense. Resolution of the question can best be had by the definition of business income. As noted previously, business income is defined in K.S.A. 79-3271(a) as "income *arising from* transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (Emphasis added.)

The inquiry is, did the transaction give rise to business income? Analyzing expenses similarly to income, to be a business expense, the transaction must be in the regular and ordinary course of business. The controlling factor in the transactional test for the determination of business income is the nature of the particular transaction giving rise to the income. BOTA is correct that under the transactional test, the borrowing of money to defend

against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense.

Affirmed.

APPENDIX F

SUPREME COURT ORDER DISTRICT CASE NO.

IN THE SUPREME COURT

OF THE STATE OF KANSAS

JOHN H WACHTER
WRIGHT HENSON SOMERS SEBELIUS
CLARK & BAKER LLP
100 SE 9TH ST 2ND FL
PO BOX 3555
TOPEKA KS 66601-3555

IN THE MATTER OF THE APPEAL OF
KROGER CO. (THE), FROM AN ORDER OF THE DIVISION OF TAXATION ON ASSESSMENT OF CORPORATE INCOME TAX. NO. 1999-83927-AS

YOU ARE HEREBY NOTIFIED OF THE FOLLOWING ACTION TAKEN BY THE COURT:

MOTION FOR TRANSFER TO THE SUPREME COURT BY APPELLANT.

GRANTED.

BOTA DOCKET NO. 1998-2850-DT

DATE: 12/09/1999.

CAROL G. GREEN
CLERK

APPENDIX G

BEFORE THE BOARD OF TAX APPEALS
OF THE STATE OF KANSAS

IN THE MATTER OF THE APPEAL
OF KROGER CO. (THE), FROM AN
ORDER OF THE DIVISION OF
TAXATION ON ASSESSMENT OF
CORPORATE INCOME TAX.

Docket No. 1998-2850-DT

ORDER DENYING RECONSIDERATION

Now, on this 19th day of August, 1999, the above captioned matter comes on for consideration and decision by the Board of Tax Appeals of the State of Kansas.

The Board finds, upon review of the Petition for Reconsideration, that no new or additional evidence is offered that would persuade the Board that the original order should be modified or that reconsideration should be granted. The Board, therefore, concludes that the Order as originally issued should be, and is hereby, sustained.

IT IS, THEREFORE, BY THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS, CONSIDERED AND ORDERED that, the above captioned Motion for Reconsideration should be, and the same is hereby, denied.

Any party choosing to petition for judicial review of the Board's decision must file the petition with the appropriate court within 30 days from the date of certification of this order. See K.S.A. 77-613(c), and amendments thereto. The Kansas Court of Appeals has jurisdiction over all property appraised and assessed by the director of property valuation, excise, income, or inheritance taxes assessed by the

director of taxation, and all tax exemptions. See K.S.A. 74-2426, and amendments thereto. The District Court in the County where the subject property is located has jurisdiction over all tax protests, grievances, and equalizations. See K.S.A. 74-2426, and amendments thereto. Pursuant to K.S.A. 77-529(c), and amendments thereto, any party choosing to petition for judicial review of the Board's decision is hereby notified that the Secretary of the Board of Tax Appeals is to receive notice of the petition for judicial review. Please note, however, that the Board would not be a party to any judicial review because the Board does not have the capacity or power to sue or be sued. See K.S.A 74-2433(f), and amendments thereto.

IT IS SO ORDERED

THE BOARD OF TAX APPEALS

[SEAL]

/s/ David L. Patton
DAVID L. PATTON,
CHAIRMAN

DISSENTING
ROBERT G. FREY,
MEMBER

/s/ Wayne C. Vennard, Jr.
WAYNE C.
VENNARD, JR.,
MEMBER

/s/ Tony R. Folsom
TONY R. FOLSOM,
ACTING SECRETARY

/s/ Jill A. Jenkins
JILL A. JENKINS,
MEMBER

/s/ Erin Hatton
ERIN HATTON,
ATTORNEY

/s/ Susan M. Seltsam
SUSAN M. SELTSAM,
MEMBER

CERTIFICATION

I, Tony R. Folsom, Acting Secretary of the Board of Tax Appeals of the State of Kansas, do hereby certify that a true and correct copy of the order in Docket No. 1998-2850-DT, and any attachments thereto, was placed in the United States Mail, on this 26th day of August, 1999, addressed to:

L. Thomas Aydt, Mgr-Income Taxes -
The Kroger Company
1014 Vine Street
Cincinnati, OH 45202-1100

John H Wachter, Attorney at Law
Wright Henson Somers Sebelius
PO Box 3555
Topeka, KS 66601-3555

and a copy was placed in capitol complex building mail, addressed to the following:

Division of Taxation
DSOB, 915 SW Harrison 1st Floor
Topeka, KS 66625-0001

Ronald H. Grant, Attorney
c/o General Counsel, Dept of Revenue
DSOB, 915 SW Harrison, 2nd Floor
Topeka, KS 66612

IN TESTIMONY WHEREOF, I have hereunto subscribed my name at Topeka, Kansas.

/s/ Tony R. Folsom
Tony R. Folsom,
Acting Secretary

APPENDIX H

BEFORE THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS

IN THE MATTER OF THE APPEAL OF KROGER CO. (THE), FROM AN ORDER OF THE DIVISION OF TAXATION ON ASSESSMENT OF CORPORATE INCOME TAX.

Docket No. 1998-2850-DT

ORDER

Now, on this 21st day of July, 1999, the above-captioned matter comes on for consideration and decision by the Board of Tax Appeals of the State of Kansas.

This Board conducted a hearing in this matter on June 11, 1999. After considering all of the evidence presented thereat, and being fully advised in the premises, the Board finds and concludes as follows:

1. The Board has jurisdiction of the subject matter and of the parties, a proper and timely appeal having been filed, pursuant to K.S.A. 74-2438, and amendments thereto.

2. The subject of this application is the assessment of additional Kansas income tax in the amount of $5,145,161, penalties in the amount of $1,286,294 and interest in the amount of $4,095,734 for a total of $10,527,189.

3. The Taxpayer, The Kroger Co., appears by John H. Wachter, Attorney at Law; L. Thomas Aydt, Manager of Income Taxes; and Charles G. Davis, Tax Manager of the Dillon Companies Group. The Department of Revenue (Department) appears by Ronald H. Grant, Attorney.

FACTS AND ISSUE

4. On November 6, 1997, the parties filed a stipulation of facts with the Secretary of Revenue's Designee and have certified the record below to the Board.

5. The issue in this appeal is whether the Taxpayer's interest expenses were incurred in the regular course of the Taxpayer's business so that the resulting loss is apportionable to Kansas.

APPLICABLE LAW

6. Pursuant to 79-32,138(a), the calculation of the taxes owed to Kansas by a corporation begins with the corporation's federal taxable income modified as described in the statute.

7. Because corporations may earn income in their state of domicile as well as other states, many states, including Kansas, adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). The act provides that a corporation's business income is apportioned between the states in which it does business and its non-business income is allocated to its state of domicile. K.S.A. 79-3272.

8. K.A.R. 92-12-76, states:

> If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with K.S.A. 79-3279.

9. Business income is defined in K.S.A. 79-3271(a) as:

> [i]ncome arising from transactions and activity in the regular course of taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Non-business income is all income other than business income. K.S.A. 79-3271(e).

10. To further define business income, Kansas courts have adopted the transactional test as described in *Western Natural Gas Co. v. McDonald* as follows:

> To constitute business income it must arise from transactions and activity in the regular course of a trade or business. Business income includes income from intangible property if the acquisition, management and disposition giving rise to the income constitute integral parts of the regular trade or business operations.

> It is not the use of the property in the business which is the determining factor under the statute. The controlling factor by which the statute identifies business income is the nature of the particular transaction giving rise to the income. To be business income the transaction and activity must have been in the regular course of the taxpayer's business operations. 202 Kan. 98, 100-101 (1968).

TAXPAYER ARGUMENTS

11. The Taxpayer asserts that its apportioning of interest expense on its Kansas income tax return was appropriate. The Taxpayer's first argument is that the Department of Revenue does not have the statutory authority to disallow the deduction as a non-business expense. The Taxpayer cites the principles of statutory interpretation of tax laws:

> The principles of interpretation and rules of statutory construction for tax laws are clear and firmly established. Tax laws are statutory and do not exist apart from the statute; as such they must be strictly construed. *Executive Aircraft Consulting, Inc. v. City of Newton*, 252 Kan. 421 (1993). Tax statutes are penal and, thus, must be strictly construed in favor of the taxpayer. *Matter of Protester Strayer*, 239 Kan. 136 (1986). Tax statutes will not be extended by implication beyond clear import of language employed therein, and their operation will not be enlarged so as to include matters not specifically

embraced. *Director of Taxation, Dep't of Revenue v. Kansas Krude Oil Reclaiming Co.*, 236 Kan. 450 (1984). Tax laws are statutory and do not exist apart from the statute and, as such, they must be strictly construed. *Application of Midland Industries, Inc.*, 236 Kan. 406 (1984). Where there is reasonable doubt as to the meaning of a taxing statute, the statute will be construed most favorably to the taxpayer. *Fleming Co. v. McDonald*, 212 Kan. 11 (1973). The solid public policy reasons for these rules are also clearly enunciated by the courts.

12. The definitions contained in K.S.A. 79-3271 (a) and (e), respectively, address "business income" and "non-business income." The Taxpayer points out that nowhere in the Kansas statutes, nor in the regulations of the Department of Revenue, is "non-business expense" defined or discussed. The Department's interpretation of the statutes to include expenses violates the principle that the statute cannot be enlarged so as to include matters not specifically embraced.

13. The Taxpayer's second argument is that if the statutory authority does exist, the activity in question is part of the Taxpayer's regular course of business. The Taxpayer cites the *In Re Appeal of Chief Industries* and *Western Natural Gas v. McDonald* cases which set forth the transactional test for business income. See Brief of Taxpayer at 4. The transactional test is a factual determination of whether the transaction leading to income was conducted in the regular

course of business. *Id.* The Taxpayer cites several other cases, including *Mobile Oil Corp. v. Commissioner of Taxes of Vermont, Exxon Corp. v. Wisconsin Dep't of Revenue,* and *General Motors Corp. v. Washington* for the proposition that the management of financial affairs falls within the regular course of business. See Brief at 7. According to the Taxpayer, its obtaining a loan to defend against a hostile takeover is a financial management decision in the regular course of business.

14. The Taxpayer points out that the interest expense was deducted as an ordinary and necessary business expense on its federal income tax return pursuant to Internal Revenue Code (IRC) § 162. The IRS did not question this deduction. The Taxpayer argues that the IRC language is similar enough to the Kansas statutory requirements in K.S.A. 79-3271(a) to be instructive on this issue. IRC § 162 allows the "deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." A case which further defines IRC § 162 is *Commissioner v. Lincoln Savings and Loan Association.* See Brief at 8. The Supreme Court said that for an expense to be deductible, it must (1) be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. *Id.* The Supreme Court case of *Commissioner v. Tellier* defined necessary expenses as those which are appropriate or helpful to the taxpayer's business. *Id.*

Expenses may be ordinary even if they occur rarely or only once according to the Supreme Court case of *Welch v. Helvering*. *Id.* Because the interest expense deduction is proper under these standards, the Taxpayer argues it also meets the regular course of business requirement of the Kansas statutes. *Id.*

15. The Taxpayer distinguishes the cases cited by the Department, including the 1997 Board Order involving Kroger. At the hearing, the Taxpayer sought to distinguish the cases cited by the Department, in which the income was ruled to be non-business in nature, on the basis that those cases involved taxable events. In each case the income resulted from the sale or purchase of assets or a safe harbor transaction. In this case, however, the borrowing of money is not a taxable event. The Board Order, certified February 13, 1997, addressed Kroger's sale of its freestanding drug stores. See Brief of Taxpayer at 5. The Taxpayer sees that case as distinguishable because the business, which existed before and after the restructuring, was a significantly different one. By contrast, in this situation, the Taxpayer is still in the same line of business following the financial restructuring.

16. The Taxpayer's third and final argument is that the assessment is not fair and equitable. The Taxpayer points out that it apportioned the interest expenses in 37 other states and none of those states have questioned the deduction. At the hearing, the

Taxpayer testified that it cannot allocate the expense disallowed in Kansas in its state of domicile either. Furthermore, Kansas has adopted UDITPA, and K.S.A. 79-3289 states that the purpose of the act is to make uniform tax laws in the states that adopt the act. The intent is to make the myriad of potential taxing laws more fair to the taxpayer and to avoid duplicate taxes. The Taxpayer asserts that the Department's position violates the intent of UDITPA because it lacks uniformity with the position of other states and causes the Taxpayer to pay duplicate taxes because it has nowhere else to take the deduction.

17. The Taxpayer also argues that the interest payments on its long-term debt are business expenses because, conversely, if the Taxpayer had invested a cash surplus, the income from the investment would be taxable as business income.

18. The Taxpayer requests the Board to abate the additional Kansas income tax of $5,145,161. The Taxpayer also requests the Board to abate the $1,286,294 in penalties and $4,095,734 in interest because the Taxpayer acted in good faith in claiming the deduction.

DEPARTMENT ARGUMENTS

19. The Department asserts that the Taxpayer's interest expense deduction was an improperly apportioned non-business expense and should have allocated to its state of domicile. The Department notes that the interest expense was the primary reason for the

loss the Taxpayer showed on its Kansas income tax return. The Department's position, supported by both case law and Department of Revenue regulations, is that the statutory definitions of both business and non-business income encompass losses as well as income.

20. In Justice Fatzer's dissent in *Amoco Production Co. v. Armold, Director of Taxation*, he states, "Finally, in conjunction with apportioning the taxable income of a multistate business is the apportionment of any losses of that business." Brief of the Kansas Department of Revenue at 5. The Department also cites a regulation, K.A.R. 92-12-76, which refers to losses as well as income.

21. The Department also relies on two cases to support its contention that the statutory definitions of business and non-business income include losses. In *National Service Industries, Inc. v. Powers*, a foreign corporation doing business in North Carolina, a UDITPA state, apportioned a loss from a safe harbor lease to North Carolina. *Id.* at 7. The court ruled that the net loss was business income. *Id.* In *Robert Half Inter. v. Franchise Tax Board*, California, the state of domicile, argued that a 7.5 million loss should be apportioned as business loss. *Id.* The Court ruled that the loss was non-business and should therefore be allocated as non-business income. *Id.* at 78.

22. The Department next argues that the Taxpayer's activity in taking out the loan did not occur in regular course of business and

thus fails the transactional test of *Western Natural Gas*. Brief of the Kansas Department of Revenue at 4. The act of defending against a hostile takeover (the transaction) was not in the regular course of Taxpayer's business, therefore the resulting interest expense and loss is non-business in nature and must be allocated to the state of domicile.

23. The Department finds the Board's 1997 Order regarding Kroger instructive on whether the transaction in question in this case is in the regular course of the Taxpayer's business. Brief of the Kansas Department of Revenue at 3. The Board stated that the gains from the sale of Kroger's freestanding pharmacies "were derived from the abandonment of a line of Kroger's business. Kroger's past business practices do not indicate that it regularly abandons certain lines of its business." *Id.* at 2. In this case, the Taxpayer incurred the debt to fight off a hostile takeover threat. The Department asserts that the Taxpayer is not in the business of fending off hostile takeover threats, and therefore the interest expense deductions are non-business expenses.

24. The Department cites another case in which the court ruled that activity in response to a hostile takeover bid was not in the regular course of business. In *Phillips Petroleum*, Phillips was domiciled in Oklahoma and doing business in Iowa, a UDITPA state. Brief of the Kansas Department of Revenue at 3. In response to a

hostile takeover bid, the company purchased its own stock, financed by the sale of assets. *Id.* at 4. The court ruled that the disposition of the assets did not occur in the regular course of petroleum production, but was a "wholesale restructuring of the corporation's capital structure." *Id.*

25. Finally, the Department raises fairness issues as well. The Department argues that it could not tax the non-business income of Kroger and conversely, should not have to allow an offset for non-business expenses that result in a loss.

FINDINGS AND CONCLUSIONS

26. As to the Taxpayer's first argument that the statute does not address expenses, the Board finds the Department's arguments to be persuasive. Case law and Department of Revenue regulations refer to losses as well as income. The expenses claimed by the Taxpayer are an integral part of the losses and should be subject to the same analysis as income.

27. The parties cited some helpful case law on business and non-business income from other states. There are no Kansas cases on point. Another case on business income is *Hercules, Inc. v. Commissioner of Revenue.* 575 N.W.2d 111 (Minn. 1998). In *Hercules,* the Taxpayer sold its stock in response to a hostile takeover threat for a net gain of over 1.3 million. *Id.* at 112. For the income to be business income, the Minnesota statute required it to be derived from carrying

on a trade or business. *Id.* at 114. A definition in the Minnesota statute provided that "intangible property is employed in a trade or business if the owner of the property holds it as a means of furthering the trade or business." *Id.* at 114-115. The Minnesota Supreme Court held that the gain from the sale of stock was non-business income because the Taxpayer's ownership and sale of the stock was not part of its day-to-day operations. *Id.* at 116. The sale was in response to a hostile takeover threat, not as a result of the need for operating income. *Id.*

28. The Board finds the *Hercules* case to be instructive on whether the activity in this case is business or non-business in nature. The Board notes that the Minnesota statute contains a broader definition of what constitutes business income than the Kansas statute. The Minnesota law would include any activity that furthers the business, while the Kansas statute requires the activity to be in the regular course of business. If *Hercules'* argument that the avoidance of a hostile takeover is in furtherance of the business fails, then the Taxpayer's argument that avoidance of a hostile takeover threat is part of the regular course of business certainly must fail. The regular course of the Taxpayer's business is the retail sale of groceries. The fending off of a hostile takeover is not activity in the regular course of selling groceries. Furthermore, the Taxpayer's obtaining a loan had nothing to do with bolstering its operating income, similar to the *Hercules* case. The

Board finds that the Taxpayer's interest expenses and resulting losses are non-business in nature and should be allocated to its state of domicile.

29. Similarly, the Board finds that the fact that the IRS has allowed the interest expense deduction under IRC § 162 to be unpersuasive. Section 162 allows the deduction for expenses incurred in "carrying on any trade or business." This standard is also broader than the statutory language in 79-3271(a) that requires the activity to be in the "regular course of taxpayer's trade or business." The Board finds that a wider range of activities might be considered part of carrying on a business, than are considered part of the defining activity of that business. Furthermore, the IRC addresses whether the expense is deductible, while the Kansas statutes at issue do not address if an expense is deductible, but where the expense may be deducted.

30. As to the fairness issues raised by the Taxpayer, the Board cannot comment on why no other states have questioned these deductions. The Board finds that another purpose of UDITPA is to make sure the taxes assessed in each state are proportionate to the business conducted in that state. This purpose would not be served by allowing the Taxpayer to deduct expenses from its Kansas income when, had there been gains, Kansas would not have been able to tax the income.

31. Finally, the Board finds and concludes that the Taxpayer's request for abatement of the

penalties in the amount of $1,286,294 and interest in the amount of $4,095,734 should be denied.

IT IS THEREFORE ORDERED BY THE BOARD OF TAX APPEALS OF THE STATE OF KANSAS that the Taxpayer's request for relief is denied.

Any party to this appeal who is aggrieved by this decision may file a written petition for reconsideration with this Board as provided in K.S.A. 77-529, and amendments thereto. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Board's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Board of Tax Appeals, DSOB Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. *A copy of the petition, together with all accompanying documents submitted, shall be mailed to all parties at the same time the petition is mailed to the Board. Failure to notify the opposing party shall render any subsequent order voidable.* The written petition must be received by the Board within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute if the Board serves the order by mail). If at 5:00 p.m. on the last day of the specified period the Board has not received a written petition for reconsideration, this order will become a final order from which no further appeal is available.

IT IS SO ORDERED

THE BOARD OF TAX APPEALS

[SEAL]

/s/ David L. Patton
DAVID L. PATTON,
CHAIRMAN

DISSENTING OPINION
ROBERT G. FREY,
MEMBER

/s/ Wayne C. Vennard, Jr.
WAYNE C. VENNARD,
JR., MEMBER

/s/ Rita Maichel
RITA MAICHEL,
SECRETARY

/s/ Jill A. Jenkins
JILL A. JENKINS,
MEMBER

/s/ Erin Hatton
ERIN HATTON,
ATTORNEY

/s/ Susan M. Seltsam
SUSAN M. SELTSAM,
MEMBER

DISSENTING OPINION

I respectfully dissent from the majority opinion. In order to decide this issue the meanings of the term "expense" must be clearly understood and considered. As stated in the above majority opinion, the Uniform Division of Income for Tax Purposes Act (UDITPA) defines only "Business income" and "Non-business income." Neither the word "loss" nor "expense" is

defined in the Kansas version of UDITPA yet both concepts are certainly factors in calculating income in the matter before us.

The impact of expenses upon the calculation of corporate income is taken into consideration by virtue of K.S.A. 79-32,138(a). As spelled out in the majority opinion, this Kansas law mandates the corporation's federal taxable income shall be used as the Kansas taxable income. As all taxpayers should know, the term "federal taxable income" is the gross income reported by the corporation from which is subtracted deductible expenses which have been incurred. Therefore, it can be said that Kansas corporate income is the balance of income which is left after all allowable expenses are deducted.

While business losses have not been defined in UDITPA, they have been incorporated by implication into the Act. See Brief of Kansas Dept. of Rev., pages 5,6,7. In the matter before us, the corporation has reported a loss that it claims should be apportioned among the states in which it does business. The Kansas Department of Revenue (KDOR), however, has taken the position that the expense that caused the reported loss claimed by the corporation is not an ordinary business expense, and therefore, it must be allocated to the state of domicile only. The result of removal of the interest expense as an "ordinary business expense" is a substantial penalty, interest and tax, which must be paid by the corporation to the State of Kansas.

It appears that the difference, which must be analyzed in deciding the issue before us, is the difference

between an "ordinary business expense" and a "non-business expense". In this case the expense in question is not unique and is easily described. In the late 1980's the corporation had become the target of an unsolicited, hostile takeover. It appears from the stipulated evidence that the corporation had become undervalued in the market with substantial assets and very little liability. In order to ward off the takeover of the company by outside interests the directors decided to borrow money which would be used primarily for the payment of dividends to stockholders of record. The purpose for this maneuver was twofold. The increased debt tends to lower the value of the company, and the excess value is returned to the current shareholders. In addition, the attraction, which the company presented to those who were interested in taking over the company, would be greatly diminished.

If there is anything unique about the expense in this case it is the size of the loan negotiated by the company and the resulting debt service expense. The loan was for $1.4 billion dollars, a very large sum in relation to the overall value of the company. In calculating federal taxable income, most loan expense is fully deductible. Most such expenses would be deemed ordinary business expenses. In this case, however, since the loan proceeds were simply paid out in dividends and since the amount of the loan and the subsequent debt payment was so large, it resulted in losses rather than taxable income.

In this case the KDOR has analyzed the debt service expense of the Kroger Company in relation to funds borrowed as a result of threatened hostile takeover. It was determined that the loss that resulted from deduction of the substantial debt service expense should be denied.

After disallowing the debt expense deduction, the KDOR determined that the corporation had, in fact, earned a profit which gave rise to additional taxes, interest and penalties totaling $10,527,189.

Of course, to say that all corporate debt is deductible may be over simplification since certain kinds of expenses might not be allowed. But if the expense were an expense that is related to the generation of corporate income it would be allowed as a deduction under the federal Internal Revenue Code. See Taxpayer's Brief at Pg. 8, *Commissioner v. Lincoln Savings and Loan Association;* see also *Commissioner v. Tellier* and *Welch v. Helvering*. It also follows that if the deductible expenses exceed the gross income, a loss will result.

I find nothing in the evidence or the law that leads me to conclude that the activity engaged in by the taxpayer in fending off a threatened hostile takeover of the Kroger Company was non-business in nature. As was stated in *Western Natural Gas Co. v. McDonald*, 202 Kan. 98, 100-101 (1968), "To be business income the transaction and activity must have been in the regular course of the taxpayer's business operations." Because expenses can be treated by the same standards as income, it can also be said that to be business *expense* the transaction and activity must have been in the regular course of the taxpayer's business operations.

Hostile takeovers do not occur often in the life of a corporation. That does not mean the measures taken by the corporate officers to fend off such an effort should be regarded as activity that is not related to the business of the corporation. (Taxpayer's Brief, Pg. 8). I'm quite

certain that the stockholders of the Kroger Co. would have been ill served by the corporate directors had they not taken action. The corporation borrowed large amounts of money and substantial debt resulting in unusually large debt service, which had to be paid by the corporation. The extraordinary magnitude of the transaction does not make it a non-business expense. Hindsight leads me to believe it was an astute business decision that possibly saved the company.

I find *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, (Minn. 1998), is not a case on point. In *Hercules* the company sold its stock to raise funds. In the case before us there is no sale of stock. In fact, no income was generated at all and the only funds raised were borrowed funds, which were used to pay a dividend. All of the transaction was related to management of the business affairs of the company.

Additionally, UDITPA spells out clearly that business income is defined as federal taxable income. Since under IRC § 162 a deduction is allowed for expenses incurred in carrying on any trade or business, it seems logical that payment of a corporate debt would qualify. Financial management of a publicly held corporation is something that must be done in the regular course of taxpayers' trade or business.

The transaction theory as set out in *In Re Appeal of Chief Industries* and *Western Natural Gas Co. v. McDonald* appears to apply in this case very well, and the only conclusion that can be drawn is clear. The losses experienced by the Kroger Company for the year in question should be allowed as business losses for

purposes of application of UDITPA. I would grant the appeal and order abatement of the $10,527,189.

/s/ Robert G. Frey
ROBERT G. FREY, MEMBER

CERTIFICATION

I, Rita Maichel, Secretary of the Board of Tax Appeals of the State of Kansas, do hereby certify that a true and correct copy of the order in Docket No. 1998-2850-DT, and any attachments thereto, was placed in the United States Mail, on this 5th day of August, 1999, addressed to:

John H. Wachter, Attorney at Law
Wright, Henson, Somers, Sebelius
PO Box 3555
Topeka, KS 66601-3555

L. Thomas Aydt, Mgr-Income Taxes
The Kroger Company
1014 Vine Street
Cincinnati, OH 45202-1100

and a copy was placed in capitol complex building mail, addressed to:

Division of Taxation
DSOB, 915 SW Harrison, 1st Floor
Topeka, KS 66612

Ronald H. Grant, Attorney
c/o General Counsel, Dept of Revenue
DSOB, 915 SW Harrison, 2nd Floor
Topeka, KS 66612

IN TESTIMONY WHEREOF, I have hereunto subscribe my name at Topeka, Kansas.

/s/ Rita Maichel
Rita Maichel, Secretary

APPENDIX I

STATE OF KANSAS *DEPARTMENT OF REVENUE*

[SEAL]

[Name And Addresses Omitted In Printing]

Office of Administrative Appeals

May 19, 1998

John H. Wachter, Attorney at Law
Wright, Henson, Somers, Sebelius,
Clark & Barker, LLP
2nd Floor, Commerce Bank Building
110 East 9th Street
P.O. Box 3555
Topeka, KS 66601-3555

Re: Written Final Determination in Request for Informal Conference for Reconsideration of Agency Action, Kroger Company, Docket Number 96-6081

Dear Mr. Wachter:

Your timely-filed petition for reconsideration was received by this office on August 20, 1996 and was docketed as number 96-6081. Kroger Company, hereinafter "Taxpayer", seeks reconsideration of the agency's June 27, 1996, assessment of additional income tax of $5,145,161.00, together with penalty of $1,286,294.00 and interest of $4,095,734.00, for a total assessment of $10,527,189.00, for the tax periods ending December 30, 1989, through January 2, 1993, inclusive.

In lieu of developing the facts of the case at an informal conference, the parties filed the following stipulation of facts with the Secretary's Designee on November 6, 1997:

1. On September 13, 1988, Taxpayer declared a special dividend to shareholders as more thoroughly explained in a letter to shareholders, dated September 26, 1988, which is attached hereto and incorporated herein by this reference as Exhibit "A".

2. In order to fund the special dividend, Taxpayer incurred long-term debt of $4,190,744,000.00 and used the proceeds of such debt to retire existing long-term debt of $846,537,000.00 and pay the special dividend to the shareholders totaling $3,347,028,000.00 as more particularly set forth in Exhibit "B", which is attached hereto and incorporated herein by this reference.

3. The interest expense paid by the Taxpayer as a result of the 1988 restructuring (the incurrance of $4,190,744,000.00 long-term debt) was properly deducted pursuant to Internal Revenue Code, Section 162 on Taxpayer's federal income tax return. Additionally, Taxpayer has consistently apportioned such interest expense on its state income tax returns filed in Kansas and other states.

4. Taxpayer's long-term debt for the years 1988 through 1992 is as reflected in the attached Exhibit "C", which is attached hereto and incorporated herein by this reference.

5. The special dividend distribution was completed in the manner set forth in detail in a letter to shareholders dated November 21, 1988, which is attached hereto as Exhibit "D" and incorporated herein by this reference.

6. On June 26, 1996, the Department assessed additional Kansas Income Tax against

the Taxpayer in the total amount of tax, penalty and interest of $10,527,189.00. Said Notice of Assessment is attached hereto as Exhibit "E" and is incorporated herein by this reference.

7. The Department's assessment omits the portion of Taxpayer's 1988 net operating loss (NOL), apportioned to Kansas of $4,241,823.00, and the parties agree that the 1988 NOL may be carried forward to subsequent tax years as provided by law.

8. The Department's assessment is based on its determination that Taxpayer's losses claimed on its Kansas returns for the tax periods ending December 31, 1989 through January 2, 1993, inclusive, constitute nonbusiness losses, and as such, should not be apportioned to Kansas.

The facts indicate that in 1988 Taxpayer borrowed $4,190,744,000.00 in order to fend off two hostile takeover attempts; one from KKR and one from The Dart Group. See Stipulations, Exhibit "D", page 3, "The Decision To Pursue The Restructuring". Taxpayer used $846,537,000.00 of the borrowed money to retire existing long-term debt, and $3,347,028,000.00 of the borrowed money to pay a special dividend of $40 per share, and a $17 per share debenture, to its shareholders. As a consequence of the loan, Taxpayer had large interest expenses in subsequent years.

Taxpayer's Kansas income tax returns for FY 12/30/89 through FY 1/2/93 all reported losses. These losses are largely a result of the interest expense paid by Taxpayer on the borrowed money. The Department audited Taxpayer's returns for these periods and assessed $10,527,189.00 in tax, penalty and interest.

The Department assessment was based on its determination that Taxpayer's losses constitute "non-business losses" which are allocable to Ohio, Taxpayer's state of domicile, and that these losses are not apportionable to Kansas.

The issues in this appeal are whether Taxpayer's interest expense in connection with its efforts to avoid a hostile take-over constitute "business" or "non-business" losses and, if the interest expense constitutes a "non-business" loss whether Taxpayer may apportion that "non-business" loss to Kansas.

The principles of interpretation and rules of statutory construction for tax laws are clear and firmly established. Tax laws are statutory and do not exist apart from the statute; as such they must be construed strictly. *Executive Aircraft Consulting, Inc. v. City of Newton,* 252 Kan. 421 (1993). Tax statutes are penal and, thus, must be strictly construed in favor of the taxpayer. *Matter of Protester Strayer,* 239 Kan. 136 (1986). Tax statutes will not be extended by implication beyond clear import of language employed therein, and their operation will not be enlarged so as to include matters not specifically embraced. *Director of Taxation, Dep't of Revenue v. Kansas Krude Oil Reclaiming Co.,* 236 Kan. 450 (1984). Tax laws are statutory and do not exist apart from the statute and, as such, they must be strictly construed. *Application of Midland Industries, Inc.,* 236 Kan. 406 (1984). Where there is reasonable doubt as to the meaning of a taxing statute, the statute will be construed most favorably to the taxpayer. *Fleming Co. v. McDonald,* 212 Kan. 11 (1973). The solid public policy reasons for these rules are also clearly enunciated by the courts.

The Kansas income tax statutes governing this appeal provide for a clear and orderly manner of taxation. K.S.A. 79-32,138(a) provides:

> (a) Kansas taxable income of a corporation taxable under this act shall be the corporation's federal taxable income for the taxable year with the modifications as specified in this section.

If a corporation has income from both within and outside of Kansas, K.S.A. 79-32,138(d) requires that its federal taxable income be allocated as provided in K.S.A. 79-3271 to 79-3293 to determine its Kansas taxable income.

K.S.A. 79-3271 to 79-3293 is the Uniform Division of Income for Tax Purposes Act (U. D. I. T. P.A.). Originally adopted by the Kansas legislature in 1963, it is designed to fairly distribute the income of a corporation doing business in several states and to prevent multiple taxation.

K.S.A. 79-3279 sets forth the statutory scheme for apportionment of the net income of a corporation. Subsection (b) provides:

> (b) All business income of any other taxpayer shall be apportioned to this state by one of the following methods:
>
> (1) by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three; . . .

The term "business income" is defined by K.S.A. 79-3271(a) as:

> (a) "Business income" means income arising from transactions and activity in the regular course of taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, . . .

Non-business income is defined by K.S.A. 79-3271(e) as all income other than business income.

The statutory scheme set forth above starts with federal taxable income. The parties have stipulated that the interest expenses which the Department seeks to disallow Taxpayer are ordinary and necessary business expenses and properly deductible pursuant to Internal Revenue Code § 162. (Stipulation of the Parties, #3.) Following the Kansas statutory scheme, federal taxable income is then allocated and apportioned pursuant to K.S.A. 79-3271, *et seq.*

In its brief, Taxpayer presents three arguments. First, Taxpayer contends there is no statutory or regulatory basis for the assessment. In support of its position Taxpayer notes neither the Department's audit report nor its prehearing questionnaire cites any statutory, regulatory or case law as a basis for its assessment. Taxpayer argues that the reason the auditor and legal staff have not cited authority for the Department' position is that none exists.

Second, Taxpayer submits that even if there is a legal basis for the assessment, denial of the deductibility of the ordinary and necessary business expenses such as interest deductions, which are the source of the assessment, must also reflect unitary concepts required by the statutes

and the fundamental fairness sought by the law. In support of its position Taxpayer notes that in adopting U.D.I.T.P.A., the Kansas legislature sought to enact a system that would provide for fundamental fairness and avoid multiple taxation. If every state has the same system of allocation and apportionment, and each state administers the system in an equitable and consistent manner, these goals are achieved.

Taxpayer notes it does business in 38 states, most of which have adopted a system of allocation and apportionment in one form or another. Only Kansas is seeking to disallow the interest deductions resulting from the 1988 refinancing. Taxpayer argues that if the Department's position prevails, it will not be able to obtain relief in other jurisdictions, none of whom utilize Kansas' unique interpretation of the statute.

Third, Taxpayer asserts that the 1988 restructuring was clearly within the ordinary course of Taxpayer's business and all transactions therefrom constitute business transactions. In support of its position Taxpayer notes Kansas statutes do not even mention, let alone define, the terms "business expenses" or "non-business expenses".

Taxpayer asserts that all of the litigation in this area revolves around the definition of the statutory term "business income". It notes the Kansas court has definitively dealt with this matter on two separate occasions. First, in *Western Natural Gas v. McDonald*, 202 Kan. 98 (1968) the court held business income includes income from intangible property if the acquisition, management and disposition giving rise to the income constitute integral parts of the regular trade or business operations. It

notes the Board has most recently reaffirmed this interpretation in *In re Tax Appeal Chief Industries,* 255 Kan. 640 (1994).

Taxpayer argues that if the situation were reversed and it had a cash surplus which it invested, the income from such investments would constitute business income apportionable under K.S.A. 79-3271, *et seq.* It notes that several courts, including the United States Supreme Court, have held that a unitary taxpayer's management of its financial affairs are part of its ordinary course of business. In this case, for business reasons and as part of its financial management, Taxpayer elected to acquire significant long term debt. Taxpayer insists that payments on its long-term debt constitute business expenses in the same manner that income from long-term investment would be business income.

Taxpayer submits that in the absence of direct statutory guidance, federal law is instructive in trying to determine what is a non-business expense. It notes the parties have stipulated that the interest expenses paid by Taxpayer as a result of the 1988 restructuring was properly deducted pursuant to Internal Revenue Code § 162 on Taxpayer's federal income tax return.

Section 162 of the Internal Revenue Code allows the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The general rules for an expense to be deductible provide the expense must (1) be paid or incurred during the taxable year, (2) be for carrying on

any trade or business, (3) be an expense, (4) be a necessary expense, and (5) be an ordinary expense. *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971). An expense is ordinary even if it rarely occurs or occurs only once within the lifetime of the taxpayer. *Welch v. Helvering*, 290 U.S. 111 (1933). Although a transaction may be unique, the question is whether the transaction is ordinary in the life of the group or community of which the taxpayer is a part. An expense is necessary if it meets the minimal requirement that the expense be appropriate or helpful for the development of taxpayer's business. *Commissioner v. Tellier*, 383 U.S. 687 (1996).

Taxpayer argues that, utilizing these well-established principles of statutory and case law, Taxpayer's deduction of interest expense incurred in preventing a hostile takeover is clearly a proper "business expense".

In its brief, the Department presents two arguments. First, the Department contends Taxpayer's activities which lead to the borrowing of over four billion dollars and the subsequent interest payments on that loan were not within Taxpayer's regular course of business.

In support of its position the Department notes that during the mid to late 1980's Taxpayer was involved in a series of "restructuring" actions. In 1986 and 1987 Taxpayer disposed of a complete line of business; its free-standing pharmacies. The sale of the free-standing pharmacies was the subject of an Order issued by the Board of Tax Appeals (BOTA), Docket No. 93-15316-DT, dated February 3, 1997.

In paragraph 26 of the February 3, 1997, Order the BOTA found that the gains from the sale of the free-standing

pharmacies "were derived from the abandonment of a line of Kroger's business. Kroger's past business practices do not indicate that it regularly abandons certain lines of its business." It also held that Taxpayer's 1988 restructuring "was the product of an action which is also not in the regular course of Kroger's business." In paragraph 27 of the Order the BOTA ruled, in light of *Western Natural Gas Co. v. McDonald*, 202 Kan. 98 (1968) that the gains were not business income subject to Kansas taxation.

The Department notes that at pages 100-101 of the *Western Natural Gas Co.* case the Court stated, with regard to the definition of "business income" that:

> Business income includes income from intangible property if the acquisition, management and disposition giving rise to the income constitute integral parts of the regular trade or business operations. It is not the use of the property in the business which is the determining factor by which the statute identifies business income. It is the nature of the particular transaction giving rise to the income. To be business income the transaction and activity must have been in the regular course of taxpayer's business operations.

The Department argues that when the *Western Natural Gas Co., Id.*, decision is read in conjunction with the decision in *In re Tax Appeal of Chief Industries*, 225 Kan. 640 (1994) it is clear the test to be applied in Kansas with regard to "business income" is the "transactional test". That is, the "transaction" giving rise to the income must be in the regular course of the taxpayer's business operations. In this case, says the Department, Taxpayer's 1988

restructuring activities were not in the regular course of its business operations.

The Department notes that the basis of its assessment is the determination that Taxpayer's activities to fend off hostile take-over bids did not occur in the regular course of Taxpayer's business. It argues that if Taxpayer can elect to allocate gains that constitute "non-business income" to its state of domicile (as it did with the gains which were the subject of the 1997 BOTA order cited above), that it should similarly be required to allocate losses that constitute "non-business income" to its state of domicile. To do otherwise, the Department insists, would prohibit Kansas from sharing in Taxpayer's bounty when a gain is realized on an activity which is not within the Taxpayer's regular course of business while requiring Kansas to share in Taxpayer's loss on an activity which similarly is not within the Taxpayer's regular course of business.

Second, the Department asserts that it does have specific authority for its current assessment against Taxpayer. It notes K.S.A. 79-32,138 provides that Kansas corporate income tax begins with "federal taxable income", line 30 of the federal return. Certain additions and subtraction modifications are made on the Kansas return, and if the corporation derives some of its income from another state in addition to deriving income from Kansas, the income is apportioned in accordance with the provisions of K.S.A. 79-3271 to K.S.A. 79-3293, inclusive. K.S.A. 79-3279(b) provides that all "business income" shall be apportioned to Kansas by one of several methods, one of which is the standard three factor formula used extensively throughout the United States.

The Department argues "federal taxable income" and "business income" can both be reported by taxpayers as a loss, as was reported by Taxpayer on the Kansas returns in question here. It insists there terms are not limited to positive numbers. In support of its position the Department points to the case of *Amoco Production Co. v. Arnold, Director of Taxation,* 213 Kan. 636, 657 (1974) where, as part of his dissent, Justice Fatzer stated:

> Finally, in conjunction with apportioning the taxable income of a multistate business is the apportionment of any losses of that business (Bass, Etc., Ltd v. Tax Comm., 266 U.S. 271, 69 L.Ed 282, 45 S.Ct. 82).

Justice Fatzer's comment was not part and parcel of the losing dissent, but was merely an observation that both gains and losses are subject to apportionment.

The Department notes that the apportionment of loss is also addressed by Kansas Administrative Regulation 92-12-76. The regulation states:

> 92-12-76. Apportionment.
>
> If the business activity in respect to any trade or business of a taxpayer occurs both within and without this state, and if by reason of such business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from such trade or business which is derived from sources within this state shall be determined by apportionment in accordance with K.S.A. 79-3279.

Given that "business income" can constitute either gain or loss, the Department goes on to argue that both Taxpayer's gains and losses can be apportioned to Kansas as

provided by K.S.A. 79-3279 (the three factor formula). Hellerstein and Hellerstein, State Taxation Vol. 1, Corporate Income and Franchise Taxes, 2nd Edition, p. 8-35. In contrast, "non-business income" is allocated to the state of the taxpayer's commercial domicile, in this case the state of Ohio. The following Kansas Administrative Regulations make this same distinction:

> 92-12-75. Definitions.
>
> (a) Apportionment means the division of business income between states by the use of a formula containing apportionment factors.
>
> (b) Allocation means the assignment of nonbusiness income to a particular state.
>
> (c) Business activity means the transactions and activity occurring in the regular course of a particular trade or business of a taxpayer.
>
> 92-12-78. Allocation.
>
> Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with K.S.A. 79-3275 through 79-3278.

The Department argues that with the issuance of *Western Natural Gas, Id.*, and more recently, *Chief, Id.*, the Department is under a duty to analyze whether the income of a multistate nondomicilary corporate taxpayer constitutes "business income" subject to Kansas apportionment or "non-business income" subject to allocation to the taxpayer's commercial domicile. It insists that same duty exists regardless of whether the transaction in question gives rise to a gain or a loss.

The Department notes that the transaction which gave rise to the loss reported by Taxpayer in this case was the borrowing of over four billion dollars, and the subsequent use of this money in fending off two hostile take-over bids. In large part, the interest expense deduction on this borrowed money was the reason for Taxpayer's reported loss. The Department points out that Taxpayer is not in the business of fending off hostile take-over bids and asserts that, as the BOTA found, these transactions and activities were not in the regular course of Taxpayer's business operations.

The Department concludes by submitting it is not disallowing Taxpayer's Section 162 expense deduction. Instead it is merely stating that the interest expense associated with the hostile take-over borrowing should not be apportioned to Kansas. The Department insists the reported loss, specifically the interest deduction, is "non-business income", and as such should be allocated to Taxpayer's state of commercial domicile. It argues the terms "business income" and "non-business income" encompass both gains and losses, and notes that both *Western Natural Gas, Id.* and *Chief, Id.* prohibit the Department from apportioning "non-business income", i.e., income which does not meet the transactional test, to Kansas.

Although there is no dispute as to the facts on which this cases rests, and there is very little dispute as to what law controls, the parties interpretation of the law and their understanding of how it should be applied to the facts of

this case is obviously quite different. The Taxpayer presents well reasoned arguments and points out the presence of certain equities which must not be ignored. The Department, however, has the stronger case.

Based on *Western Natural Gas, Id.*, and more recently, *Chief, Id.*, the Department is under a duty to analyze whether the income of a multistate nondomicilary corporate taxpayer constitutes "business income" subject to Kansas apportionment or "non-business income" subject to allocation to the taxpayer's commercial domicile. For the reasons set forth in the Department's arguments, the phrases "business income" and "non-business income" clearly refer to both income and loss. Therefore, if the losses in question are "non-business income" they must be allocated to Taxpayer's commercial domicile.

In this case, the losses arose from interest expense associated with Taxpayer's borrowing of over four billion dollars to fend off a hostile take-over. The transactions and activities of Taxpayer in defending against the hostile take-over were not in the regular course of Taxpayer's business operations. As such, they are "non-business income (loss)" and cannot be apportioned to Kansas.

The Department's assessment does not disallow Taxpayer's Section 162 expense deduction. Instead, the interest expense associated with the hostile take-over borrowing is allocated to Taxpayer's state of commercial domicile. This is in accordance with Kansas law, and in keeping with the principals applied by the BOTA with regard to gains earned by Taxpayer in 1986 and 1987.

Accordingly, upon reconsideration pursuant to K.S.A. 79-3226, as amended, I find that the decision appealed

from in this matter is consistent with state law and the Department's assessment is upheld.

This final determination constitutes final agency action subject to administrative review by the state board of tax appeals. If you wish to appeal this decision, you must file a notice of appeal, pursuant to K.S.A. 74-2438, with the secretary of the Board of Tax Appeals within thirty (30) days of this final determination and serve a copy of such notice upon the Secretary of Revenue or Secretary's Designee.

Very truly yours,
John D. LaFaver, Secretary
Kansas Department of Revenue
Docking State Office Building
Topeka, KS 66612
(913) 296-3041

Office of Administrative Appeals

MD
Certified Mail

cc: Ronald H. Grant, Legal Services

APPENDIX J

SUPREME COURT ORDER DISTRICT CASE NO.

IN THE SUPREME COURT

OF THE STATE OF KANSAS

JOHN H WACHTER
WRIGHT HENSON SOMERS SEBELIUS
CLARK & BAKER LLP
100 SE 9TH ST 2ND FL
PO BOX 3555
TOPEKA KS 66601-3555

IN THE MATTER OF THE APPEAL OF KROGER CO. (THE), FROM AN ORDER OF THE DIVISION OF TAXATION ON ASSESSMENT OF CORPORATE INCOME TAX. NO. 99-83927-AS

YOU ARE HEREBY NOTIFIED OF THE FOLLOWING ACTION TAKEN BY THE COURT:

MOTION FOR REHEARING OR MODIFICATION BY APPELLANT, THE KROGER CO.

CONSIDERED BY THE COURT, NOTED AND DENIED.

RESPONSE NOTED.

BOTA DOCKET NO. 1998-2850-DT

DATE: 12/15/2000.

CAROL G. GREEN
CLERK

APPENDIX K

Kansas Statutes Annotated Involved*

§ 79-3271. Apportionment of net income; definitions.

As used in this act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, investment company, or any type of insurance company, but such term

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* The Kansas statutes reproduced in this Appendix are the versions that existed at the inception of the period at issue. During the period at issue, two of the statutes, sections 79-3271 and 79-3279, were amended in minor respects having no bearing upon the controversy before this Court.

shall not be deemed to include any business entity, other than those hereinbefore enumerated, whose primary business activity is making consumer loans or purchasing retail installment contracts from one or more sellers.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity which owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, or the production, storage, transmission, sale, delivery, or furnishing of electricity, water, steam, oil, oil products or gas.

(g) "Sales" means all gross receipts of the taxpayer not allocated under K.S.A. 79-3274 to 79-3278.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

---

§ 79-3274. Apportionment of net income; nonbusiness income allocation.

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in K.S.A. 79-3275 to 79-3278, inclusive, and amendments thereto. Allocable nonbusiness income shall be limited to the total

nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year.

---

§ 79-3275. Same; rents and royalties; extent of utilization of tangible personal property.

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state:

(1) if and to the extent that the property is utilized in this state, or

(2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the

state in which the property was located at the time the rental or royalty payer obtained possession.

---

§ 79-3276. Same; capital gains and losses from sales of property.

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if

(1) the property had a situs in this state at the time of the sale, or

(2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

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§ 79-3277. Same; interest and dividends.

Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

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§ 79-3278. Same; patent and copyright royalties.

(a) Patent and copyright royalties are allocable to this state:

(1) if and to the extent that the patent or copyright is utilized by the payer in this state, or

(2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

———

§ 79-3279. Apportionment of net income; apportionment of business income; rules for railroads and interstate motor carriers.

(a) All business income of railroads and interstate motor carriers of persons or property for-hire shall be apportioned to this state by multiplying the business income by a fraction, in the case of railroads, the numerator of which is the freight car miles in this state and the denominator of which is the freight car miles everywhere, and, in the case of interstate motor carriers, the numerator of which is the total number of miles operated in this state and the denominator of which is the total number of miles operated everywhere.

(b) All business income of any other taxpayer shall be apportioned to this state by one of the following methods:

(1) By multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three; or

(2) at the election of a qualifying taxpayer, by multiplying the business income by a fraction, the numerator of which is the property factor plus the sales factor, and the denominator of which is two.

(A) For purposes of this paragraph, a qualifying taxpayer is any taxpayer whose payroll factor for a taxable year exceeds 200% of the average of the property factor and the sales factor. Whenever two or more corporations are engaged in a unitary business and required to

file a combined report, the percentage comparison provided by this paragraph shall be calculated by using the payroll factor, property factor and sales factor of the combined group of unitary corporations.

(B) An election under this paragraph shall be made by including a statement with the original tax return indicating that the taxpayer elects to apply the apportionment method under this paragraph. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations. Notwithstanding the above, the secretary of revenue may upon the request of the taxpayer, grant permission to terminate the election under this paragraph prior to expiration of the ten-year period.

---

§ 79-32,138. Kansas taxable income of corporations.

(a) Kansas taxable income of a corporation taxable under this act shall be the corporation's federal taxable income for the taxable year with the modifications specified in this section.

(b) There shall be added to federal taxable income: (i) The same modifications as are set forth in subsection (b) of K.S.A. 79-32,117, and amendments thereto, with respect to resident individuals.

(ii) The amount of all depreciation deductions claimed for any real or tangible personal property upon

which the deduction is allowed by K.S.A. 79-32,161, and amendments thereto.

(iii) The amount of all depreciation deductions claimed for any property upon which the deduction allowed by K.S.A. 79-32,168, and amendments thereto, is claimed.

(iv) The amount of any charitable contribution deduction claimed for any contribution or gift to or for the use of any racially segregated educational institution.

(c) There shall be subtracted from federal taxable income: (i) The same modifications as are set forth in subsection (c) of K.S.A. 79-32,117, and amendments thereto, with respect to resident individuals.

(ii) The federal income tax liability for any taxable year commencing prior to December 31, 1971, for which a Kansas return was filed after reduction for all credits thereon, except credits for payments on estimates of federal income tax, credits for gasoline and lubricating oil tax, and for foreign tax credits if, on the Kansas income tax return for such prior year, the federal income tax deduction was computed on the basis of the federal income tax paid in such prior year, rather than as accrued. Notwithstanding the foregoing, the deduction for federal income tax liability for any year shall not exceed that portion of the total federal income tax liability for such year which bears the same ratio to the total federal income tax liability for such year as the Kansas taxable income, as computed before any deductions for federal income taxes and after application of subsections (d) and (e) of this section as existing for such year, bears to the federal taxable income for the same year.

(iii) An amount for amortization of the amortizable costs of a certified oil production process as computed under K.S.A. 79-32,161, and amendments thereto.

(iv) An amount for the amortization deduction for a solar energy system allowed pursuant to K.S.A. 79-32,168, and amendments thereto.

(v) For all taxable years commencing after December 31, 1987, the amount included in federal taxable income pursuant to the provisions of section 78 of the internal revenue code.

(vi) For all taxable years commencing after December 31, 1987, 80% of dividends from corporations incorporated outside of the United States or the District of Columbia which are included in federal taxable income.

(d) If any corporation derives all of its income from sources within Kansas in any taxable year commencing after December 31, 1979, its Kansas taxable income shall be the sum resulting after application of subsections (a) through (c) hereof. Otherwise, such corporation's Kansas taxable income in any such taxable year, after excluding any refunds of federal income tax and before the deduction of federal income taxes provided by subsection (c)(ii) shall be allocated as provided in K.S.A. 79-3271 to K.S.A. 79-3293, inclusive, and amendments thereto, plus any refund of federal income tax as determined under paragraph (iv) of subsection (b) of K.S.A. 79-32,117, and amendments thereto, and minus the deduction for federal income taxes as provided by subsection (c)(ii) shall be such corporation's Kansas taxable income.

(e) A corporation may make an election with respect to its first taxable year commencing after December 31, 1982, whereby no addition modifications as provided for in subsection (b)(ii) of K.S.A. 79-32,138 and subtraction modifications as provided for in subsection (c)(iii) of K.S.A. 79-32,138, as those subsections existed prior to their amendment by this act, shall be required to be made for such taxable year.

(2)

Supreme Court, U.S.
FILED
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CLERK

No. 00-1422

IN THE

Supreme Court of the United States

THE KROGER CO.,
Petitioner,

v.

THE KANSAS DEPARTMENT OF REVENUE,
Respondent.

On Petition for Writ of Certiorari to the Supreme Court of Kansas

BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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21pp

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INTEREST OF THE *AMICUS CURIAE*

The Committee On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 550 multistate corporations involved in interstate and international commerce.

COST submits this brief to highlight a new and expanding approach states are using to unconstitutionally expand their tax base. On the heels of this Court's decision in *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000), Kansas seeks to impose "a deduction limitation [that] would seem, in fact, to amount to an impermissible tax." *Id.* at 465. Kansas has reached beyond its borders to unconstitutionally extract taxes from an interstate business by requiring the business to allocate its interest expense to another state. *Amicus* hopes that the Court will not allow this type of unconstitutional expense disallowance to occur after *Hunt-Wesson*. Failing to grant Certiorari would encourage taxing authorities to use this new method of expense disallowance as a means of expanding their tax base. Such a diminution in taxpayers' constitutional protection threatens the foundations of the state tax system by risking excessive burdens on commerce. COST and its members are concerned that such burdens could become institutionalized elements of state tax

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of the Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

systems. Further, Kansas' statutory provision governing apportionability is shared by many states. Thus, the Court's action on the Petition for Writ of Certiorari in this case will instruct states whether such provisions may be used to expand the tax base as Kansas has done. COST and its members have a particular interest in seeing the Kansas approach to expense disallowance reviewed (and invalidated) both because of the direct impact on the efforts of the tax department in Kansas and the resulting impact on states attempting this approach across the country. COST and its members request this Court to reiterate and expound upon the constitutional principles prohibiting the tax on extraterritorial values suffered by Petitioner and many similar taxpayers in Kansas and elsewhere.

SUMMARY OF THE ARGUMENT

COST asks this Court to accept the case and determine that Kansas violated the Due Process and Commerce Clauses of the United States Constitution by taxing income with no relation to the state. Taxation of extraterritorial value occurs here, as in *Hunt-Wesson*, as a result of the State's denial of the Petitioner's interest deduction in violation of the unitary business principle. Reducing a tax benefit (*i.e.*, a deduction) generates the same result as taxing the nonunitary income directly. States cannot end-run the unitary business limitation by disguising a tax on extraterritorial income as an expense disallowance.

The unconstitutional treatment of Kroger's interest expense stems from the State using its rule for apportioning income to determine whether an expense should be apportioned or allocated. This Court established the unitary business principle as the backstop for determining the scope of a state's constitutional ability to reach income. The principle defines the outermost parameters of a state's ability to subject income to tax. Within that limitation, many states have

legislatively adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Compared to the parameters established by the unitary business principle, UDITPA statutorily captures a narrower spectrum of income for apportionment. Several state tax authorities have drawn the conclusion that UDITPA's definition of income subject to apportionment, "business income," relies on two tests, the transactional and functional tests, which, when combined, result in a defined tax base falling, necessarily, within the constitutional definition of "unitary" income. The courts of the State of Kansas have interpreted UDITPA, and narrowed the scope of income subject to apportionment by adopting only the transactional test of UDITPA. Although these narrower tests suffice for determining *income* subject to apportionment, and states are within their prerogative in doing so, application of a narrower test to determine *expense disallowance* creates an unconstitutional violation of the unitary business principle by calculating "business income" in an amount that exceeds Kroger's total unitary income. It is the narrow transactional test that Kansas applied to determine that Kroger's interest expense should be allocated instead of apportioned.

Because the disallowance of expenses results in the indirect taxation of income, any test, whether applied to an item of income or expense, which results in apportionable income in excess of "unitary" income, is not permissible. In this case, when the narrow transactional test is applied to expense determination, it disallows expenses that meet the Constitution's broader unitary business principle. As a result, expenses which were clearly related to the unitary business (but didn't satisfy the Kansas transactional test) were disallowed, thereby subjecting the taxpayer to tax on extraterritorial value in the same manner that California's unconstitutional interest disallowance was held to impermissibly result in taxation of nonunitary income.

ARGUMENT

I. Under the Due Process and Commerce Clauses of the United States Constitution, the Unitary Business Principle Operates to Limit the Income that Kansas May Include in its Apportionable Tax Base.

Although this case involves a state's effort to disallow an apportioned expense, Kansas used the rules for apportioning and allocating income to reach its determination. Whether used to apportion income or deny an apportioned expense, these rules impact the amount of income subject to tax by the State and must therefore be analyzed under the constitutional standards applicable to taxation of multistate businesses. Both the Commerce and the Due Process Clauses limit a state's ability to tax a nondomiciliary corporation's multistate income. U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1. Consistent with these constitutional limitations, a state's ability to tax income earned by a multistate business requires a "minimal connection" between the interstate activities of the corporation and the taxing state. *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 436-437 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978)); *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345 (1954). States are prohibited from taxing a nondomiciliary corporation's income, if that income is "derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.' " *Exxon Corp. v. Department of Revenue of Wis.*, 447 U.S. 207, 224 (1980)(quoting *Mobil Oil*, 445 U.S. at 442).

These principles form the umbrella that is the unitary business principle applicable to income. Only income falling under this umbrella may be taxed on an apportioned basis by a nondomiciliary state. A variety of relationships between the income and the state will place the income under the umbrella. For example, the income may have been directly

earned by activities within the state—a sales person selling the taxpayer's product in the state; the income may also be taxed if it is attributable to activities both within and outside the state and is part of the taxpayer's "unitary business." *Mobil Oil*, 445 U.S. at 438. States are prohibited, however, from taxing income that bears no rational relationship to the in-state value of the corporate enterprise. *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768, 772, (1992).

In determining whether the appropriate relationship exists, this Court has said that the "linchpin of apportionability in the field of state income taxation is the unitary business principle." *Mobil Oil*, 445 U.S. at 439. The Court in *Mobil Oil* looked to three factors to determine the existence of a unitary business: 1) functional integration; 2) centralization of management; and 3) economies of scale. *Id.* at 438. The Court held that Mobil failed to prove that the state was taxing extraterritorial value. A taxpayer must show that its income was earned in a discrete enterprise, unrelated to the activities pursued in that state, to prove that income is not subject to apportionment. *Id.* at 439.

The Court further refined the unitary business principle in *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159 (1983). In *Container Corp.*, the Court's analysis relied on *Mobile Oil* and distinguished between a capital transaction that serves an investment function and one that serves an operational function. *Id.* at 180, n.19. The Court noted that a unitary business might be shown without a flow of goods between entities, as long as there is a flow of value.

Most recently, in *Allied-Signal, Inc. v. Director, Div. of Tax'n*, 504 U.S. 768 (1992), the Court struck down New Jersey's efforts to include nonunitary income in the tax base. In its decision the Court reaffirmed the unitary business principle as the appropriate standard for limiting a state's power to tax value outside its borders. The Court also rejected the Multistate Tax Commission's (MTC) request that

the Court adopt the Uniform Division for Tax Purposes Act (UDITPA) definition of "business income" as the standard for the unitary business principle. *Id.* at 786; UDITPA § 1(a). Instead, the Court articulated the test for determining apportionable income, which it phrased in terms of the relationship between the income and the operations of the taxpayer in the taxing state; income resulting from investment is insufficient. *Allied-Signal,* 504 U.S. at 787. Under this test, a transaction or activity generates apportionable income if "the capital transaction serve[s] an operational rather than an investment function." *Id.* at 787.

As summarized above, this Court's prior decisions have created a broad range of tests to determine whether income is unitary and thus apportionable. These tests, when taken together, establish the outermost edge of the unitary business umbrella. Although states may tax a share of income falling under the umbrella, a state that tries to tax income outside the umbrella is constitutionally all wet.

II. The Uniform Division of Income for Tax Purposes Act (UDITPA) Statutorily Narrows the Income that States May Include in their Apportionable Tax Base and Kansas' Interpretation of UDITPA Further Narrows the Tax Base by Adopting Only the Transactional Test.

In understanding the rules for apportionment, one must look not only at the unitary umbrella but also at the statutory rules states use to define the scope of income they seek to tax. In that regard, the Uniform Division of Income for Tax Purposes Act (UDITPA) establishes general definitions of income used to accomplish distribution of income through allocation and apportionment among the states. Rather than rely on the unitary business principle, UDITPA separates income into items that are apportionable, which it calls business income, and items that are allocable, which it calls nonbusiness income. These definitions, when compared with

the scope of the unitary income umbrella, are somewhat narrower than the income states are constitutionally permitted to tax. UDITPA was drafted in an effort to develop a uniform method of making apportionment and allocation decisions. In 1956, the first draft of UDITPA was presented to the National Conference of Commissioners on Uniform State Laws (NCCUSL).[2] The original draft did not distinguish between business and nonbusiness income but simply assigned certain intangible income and capital gains to the corporation's commercial domicile. The draft was revised in 1957 using the current business/nonbusiness income test to determine whether income should be allocated or apportioned.[3] Kansas adopted its original version of UDITPA in 1963.[4]

UDITPA § 1(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Id.* Nonbusiness income is defined as "all income other than business income." UDITPA § 1(e).

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[2] The history of the UDITPA is taken from William J. Pierce, *The Uniform Division of Income for State Purposes*, Taxes-the Tax Magazine Vol. 35 No. 10 (October 1957), and James H. Peters, *The Distinction Between Business Income and Nonbusiness Income*, 1973 So. Cal. Tax Inst. 251.

[3] *Id.;* Unif. Div. of Income for Tax Purposes Act § 1, 7A U.L.A. 336 (West 1985 & Supp. 1995).

[4] Kan. Stat. Ann. §§ 79-3271 to 79-3293. Twenty-one other states plus the District of Columbia have adopted some form of UDITPA language including: Alabama, Alaska, Arizona, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington.

In several states, the UDITPA business income definition has been interpreted as incorporating two alternative tests for determining whether income is business income: the transactional test and the functional test.[5] The transactional test requires that income be considered business income if it arises from transactions and activities in the regular course of the taxpayer's trade or business. UDITPA § 1(a). For example, a sale of a factory by the business would be considered unusual and extraordinary, and thus, would fail the transactional test as being outside the regular course of business. Under the functional test, however, if the acquisition, management, and disposition of the asset generating the income constitutes an integral part of the taxpayer's regular trade or business operations, the income will be considered apportionable business income. The functional test focuses on the relationship between assets giving rise to taxable income and the business itself. Under the functional test, the gain or loss from the sale would be considered business income if the factory was acquired and used in the taxpayer's trade or business. If either test is satisfied, the income is business income. In states that use the transactional test as the sole test for classifying income, like Kansas, the gain on the sale of the factory would not be business income because the sale was not in the regular course of the taxpayer's business. Transactional-test states, therefore, have a much narrower approach to determining apportionable income than do states with both tests or states that rely entirely on the unitary business concept to determine apportionable income.[6]

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[5] *See* 1 John C. Healy, *2001 Multistate Corporate Tax Guide: Corporate Income Tax*, at I-660 (2001).

[6] We do not contend that the statutory UDITPA language includes one or two tests, a matter left for state courts to reach in interpreting their state statutes.

In *Allied-Signal*, this Court was encouraged to adopt the business/nonbusiness income tests of UDITPA as the constitutional test for the unitary business principle. *Allied-Signal*, 504 U.S. at 786. Refusing to equate the flexible unitary business principle with the inflexible statutory language of UDITPA, the Court was only willing to go as far as stating "[i]n the abstract, these definitions may be quite compatible with the unitary business principle." *Id.* at 786. In fact, they are compatible in that the business income concept of UDITPA fits within the unitary income concept developed by this Court; and, the nonbusiness income concept of UDITPA similarly fits within nonunitary income. The UDITPA standard is but a subset of the unitary concept. By its very nature, the flexibility of the unitary concept encompasses a broader scope of income than the statutory provisions of UDITPA.

Even states that have interpreted their statute to contain both tests do not capture all of the income under the unitary business umbrella. UDITPA does not contain any "requirement that [its] business income definition extend as far as the Constitution permits." 1 Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, § 9.05[1][b] (3d ed. 1998). The cases litigating whether the business income definition includes one or two tests are not "seriously influenced by federal constitutional restraint." *Id.* Whether states have adopted one or both the transactional or functional tests, the state statute forms an umbrella fitting within the unitary business umbrella.[7]

The narrowness of UDITPA can be clearly seen by comparing the statutory provisions of "full apportionment" states like Massachusetts with the UDITPA states' definition of business income. As an example, Massachusetts requires

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[7] Some state courts have inappropriately interpreted UDITPA in a manner that is broader than allowed by the unitary business principle.

corporate taxpayers to apportion all income if they have business activity taxable both within and without the State. Mass. Gen. Laws ch. 63, § 38(c). The only limit on Massachusetts' full apportionment provision is the unitary business principle. This limit, not even appearing in the State's statute, was clarified in Massachusetts Department of Revenue Technical Release 92-5, (October 9, 1992 TIR 92-5). Accordingly, although the State statute requires that taxpayers apportion every dollar of income, the State's TIR requires taxpayers to exclude income which is nonunitary so as not to violate the unitary business principle. According to TIR 92-5, only income qualifying as nonunitary under the principles enunciated in *Allied-Signal* may be excluded from the apportionable base. Using this approach, Massachusetts seeks to apportion the full amount of income that is constitutionally permissible.

Maryland is another jurisdiction that has adopted statutory provisions much broader than UDITPA. Md. Code Ann. Tax-Gen. § 10-402, requires a unitary business to allocate to the State that part of the corporation's income "derived from or reasonably attributable to trade or business carried on in the State." *Id.* In *Hercules Inc. v. Comptroller of the Treasury*, 716 A.2d 276 (Md. 1998). the Court of Appeals of Maryland held that "[t]he legislative purpose underlying this statute is to tax multi-state corporations doing business in Maryland to the bounds permitted by the United States Constitution." *Id. at 280.* By regulation the State makes clear that apportionment is required of any income generated by a unitary business. Md. Regs. Code tit. 03 § 04.03.08 (2001). Again, the State's statute and regulations go further than UDITPA and reach the full extent of constitutionally permissible taxation.

In 1963, Kansas adopted its version of UDITPA contained in Kan. Stat. Ann. §§ 79-3271 to 79-3293, which is modeled on the Uniform Division of Income for Tax Purposes Act

(UDITPA). Kan. Stat. Ann. § 79-3271(a) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Kansas defines nonbusiness income as "all income other than business income." Kan. Stat. Ann. § 79-3271(e). The Kansas Supreme Court interpreted the State's version of UDITPA as containing only the transactional test in *Western Natural Gas Co. v. McDonald*, 446 P.2d 781 (Kan. 1968). This decision was affirmed in *In the Matter of the Appeal of Chief Industries, Inc.*, 875 P.2d 278 (Kan. 1994).[8]

The Kansas *Chief Industries* case is a prime example of the narrowing of apportionable income accomplished by the transactional test. Chief Industries was headquartered in Nebraska and owned a recreational vehicle production facility in Kansas. In 1972, Chief Industries established an automotive division, Chief Automotive, to produce and sell automobile frame straighteners. By 1983, Chief Industries was experiencing liquidity problems. To raise capital, Chief

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[8] In addition to Kansas, other states such as Iowa, New Mexico and Tennessee found that their state's version of UDITPA's business income definition contained only a transactional test. *See Phillips Petroleum Co. v. Department of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993); *McVean & Barlow Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (N.M. Ct. App. 1975); *General Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986); *Federated Stores Realty, Inc. v. Huddleston*, 852 S.W.2d 206 (Tenn. 1992); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993); *Associated Partnership I, Inc. v. Huddleston*, 889 S.W.2d 190 (Tenn. 1994). However, strict use of the transactional test caused a substantial loss of revenue, forcing Kansas, New Mexico and Tennessee to amend their statutes. Now, those states generally accept both the transactional and the functional tests to determine whether income is apportionable business income.

Industries separately incorporated Chief Automotive selling stock at public offering to raise $30 million in funds, which were used for the general business needs of Chief Industries. On audit, the Kansas Department of Revenue challenged Chief Industries' allocation of its stock sale proceeds as nonbusiness income.

The Department argued in *Chief Industries* that the *Allied-Signal* decision mandated the use of an independent functional test when determining whether income falls under the UDITPA definition of "business income." On appeal, the Supreme Court of Kansas rejected the Department's argument and interpreted the Kansas statute to contain only the transactional test, relying on *Western Natural Gas*. Using the transactional test, the Supreme Court of Kansas found that the gain from the sale of stock was nonbusiness income and, therefore, not apportionable to Kansas. The Supreme Court of Kansas could have reached a different result had it applied the functional test. The decision did not criticize the lower court's application of the functional test to Chief Industries' stock sale; instead, the Court focused solely on whether the functional test existed under Kansas' version of UDITPA and *Western Natural Gas*. Had the Kansas UDITPA provision been interpreted to include the functional test, *Chief Industries* might have been decided differently.[9] In fact, the Kansas legislature recognized the narrowness of the State's transactional test and amended the State's version of UDITPA to provide for an elective functional test. Income Tax Unif. Div. of Income for Tax Purposes Act, L. 1996, ch. 264, § 1; July 1.

Kansas' transactional test for determining apportionable income reaches a narrower scope of income than state

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[9] The Board of Tax Appeals found that the gain on the sale of stock qualified as business income under the functional test but not under the transactional test. *Chief Industries*, 875 P.2d at 281.

UDITPA provisions, which have been interpreted to contain both tests. The Kansas' transactional test also reaches a much narrower scope of income than permitted by the constitution's unitary business principle. Although Kansas is entitled to statutorily refrain from taxing the full extent of income permitted by the Constitution, it cannot use the narrow income test to determine whether to allow the deduction of apportioned expenses. By using the transactional test, Kansas' focus on whether the interest expense at issue was in the regular course of the taxpayer's trade or business misses the boat. The appropriate analysis is that used by this Court in *Hunt-Wesson*, whether the expense disallowance results in taxation of extraterritorial value. Using the narrow transactional test, and failing to apply the broader unitary business principle to expenses results in expense disallowance that is tantamount to the imposition of tax on extraterritorial income.

III. Kansas' Application of the UDITPA Transactional Test to Disallow Expenses Results in Tax on Extraterritorial Values.

Kansas' application of the transactional test to Kroger's interest expense resulted in taxation of extraterritorial values. When compared with the two UDITPA tests or the unitary business principle, the transactional test excludes a broader scope of income from apportionment. In its application to expenses, the transactional test also eliminates a broader scope of deductions. Because the disallowance of expenses results in the indirect taxation of income, the transactional test is not an appropriate means to analyze whether expenses should be allocated or apportioned. When the narrow transactional test is applied to expense determination, it disallows expenses that are deductible in calculating total unitary income subject to tax. By doing so, Kansas has gone beyond what is constitutionally permitted. Had Kansas analyzed Kroger's expense under the unitary business

concept, the expense would have been allowed as a deduction apportioned against unitary income, regardless of the expense's characterization under Kansas' statutes. The interest expense at issue is the flip side of interest income from working capital, something clearly subject to apportionment under the unitary business principle. *Allied-Signal,* 504 U.S. at 787. Interest on borrowed capital should be treated the same as interest earned on invested capital. In failing to apply the unitary business concept to this interest expense, Kansas disallowed the entire interest deduction, thereby subjecting Kroger to tax on extraterritorial value in the same manner that California's unconstitutional interest disallowance was held to impermissibly result in taxation of nonunitary income in *Hunt-Wesson.*

Both the Commerce and the Due Process Clauses limit a state's ability to tax value earned outside its borders. U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 1. States cannot end-run the constitutional limitations by disguising a tax on extraterritorial income as an expense disallowance. The question before the Court in *Hunt-Wesson* was "[d]oes the Constitution permit California to carve out an exception to its interest expense deduction, which it measures by the amount of nonunitary dividend and interest income that the nondomiciliary corporation has received?" *Hunt-Wesson,* 528 U.S. at 463. The question before this Court is similar; does the Constitution permit Kansas to carve out an exception to its interest expense deduction, which it measures by the transactional test? Because the transactional test does not parallel the unitary business concept, and, in fact is much narrower, it results in the disallowance of interest beyond that permitted by the Constitution.

As in the present case, the California statute at issue in *Hunt-Wesson* did not directly impose a tax on nonunitary income. Rather, it denied the taxpayer use of a portion of its interest deduction from unitary income. *Hunt-Wesson,* 528

U.S. at 464. However, as the Court in *Hunt-Wesson* recognized, a " 'tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.' " *Id.* at 464 (citing *Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 374 (1991), quoting Jenkins, *State Taxation of Interstate Commerce*, 27 Tenn. L. Rev. 239, 242 (1960)). Similarly, a deduction limitation on unitary expenses measured by the state's definition of "nonbusiness expenses" is a tax on nonunitary income to the extent the state applies a test narrower than the unitary business principle to expense determination.

Although California's interest offset (deduction reducing) provision operated to increase the amount of income subject to taxation (by reducing the deduction by precisely the amount of nonunitary income that the taxpayer received), the present method of reducing interest accomplishes the same end by slightly different means. Unlike *Hunt-Wesson*, Kansas ignores whether Kroger has nonunitary income in determining whether to disallow the interest expense. Instead, Kansas completely disallowed Kroger's interest deduction by applying a test known to be narrower than the unitary business concept.

The Court, in *Hunt-Wesson*, recognized that deduction denials that "represent reasonable efforts properly to allocate a deduction between taxable and tax-exempt income" are constitutional. *Hunt-Wesson*, 528 U.S. at 466. Because California's interest offset provision did not reasonably allocate deductions to the income that the expense generated, this Court held that the provision "constitutes impermissible taxation of income outside its jurisdictional reach." *Id.* at 468. Kansas' absolute denial of interest expense based on the transactional test's restrictive view does not represent a reasonable attempt to pair unitary income and unitary expenses. To the extent the State's definitions of business income and business expense mirror the constitutional

limitations, no problem exists; to the extent the State's definitions are narrower than the constitutional limitations, the State unreasonably pairs unitary expense with nonunitary income.

States that use the "business income" standard to determine whether expenses should be apportioned violate the unitary business principle as long as the state has defined the business income test to be something narrower that the unitary business principle. This approach fails to meet constitutional requirements and is compounded in states that use only the transactional test. While states may narrowly capture income from activities meeting the transactional or functional test (whichever the state imposes) in their apportioned tax base, using the same rules to apportion or allocate expenses will violate the unitary business principle.

The Court has the opportunity in this case to further its analysis identifying expense disallowance that results in unconstitutional taxation of extraterritorial values and, more importantly, to offer state taxing jurisdictions a template to prevent future violations. While this Court has recently affirmed that a state may not tax extraterritorial values through unreasonable expense disallowance, states have failed to recognize that *Hunt-Wesson* applies outside California.[10] As a result, states rely on a variety of incomplete shortcuts—such as the application of UDITPA or the transactional or functional tests—to determine which expenses must be allocated or apportioned. These shortcuts, while in some cases sufficient to meet constitutional strictures, fail in other situations (as evidenced here) to protect the taxpayer's constitutional rights. Thus, a decision by the Court in the present case is necessary to explain the

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[10] We would respectfully suggest the Court to note California's attempt to reduce *Hunt-Wesson* to a historical anomaly by means of administrative promulgation. *See* Cal. Franchise Tax Bd. Notice 2000-9 (Dec. 19, 2000).

constitutional limitations against taxing extraterritorial values and establish the test for determining when such limits are violated by expense disallowance.

CONCLUSION

For the reasons stated above, and because this approach to expense disallowance is spreading to other states, COST respectfully requests the Court to accept this case for review.

Respectfully submitted,

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Supreme Court, U.S.
FILED
APR 11 2001
OFFICE OF THE CLERK

No. 00-1422

IN THE

Supreme Court of the United States

THE KROGER CO.,
Petitioner,

v.

THE KANSAS DEPARTMENT OF REVENUE,
Respondent.

On a Petition for a Writ of Certiorari to the Supreme Court of Kansas

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of the Supreme Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of Petitioner.[1] Tax Executives Institute (hereinafter "TEI" or "the Institute") is a voluntary, nonprofit association of corporate and other business

[1] Pursuant to Rule 37.6, *amicus* TEI states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Tax Executives Institute has received the written consents of Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 5,300 members who represent nearly 2,800 of the leading businesses in the United States, Canada, and Europe, nearly all of which are engaged in interstate commerce.

The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws throughout the Nation, to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and to vindicating the due process and Commerce Clause rights of business taxpayers.

The overarching issue in this case is whether the disallowance of an interest expense deduction attributable to a loan used, in part, to defend against a hostile takeover attempt is at odds with the holding of this Court last term in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). In that case, the Court unanimously invalidated a California statute that impermissibly assumed that all borrowings by a nondomiciliary taxpayer supported its nonunitary investments. The holding of *Hunt-Wesson* is essentially this: *Because the California statute did not reasonably allocate expense deductions to the income that the expenses generated, the statute violated the Due Process and Commerce Clauses of the U.S. Constitution.*

The constitutional rights of many if not most companies represented by TEI members are implicated and, indeed, potentially threatened by the decision of the Kansas Supreme Court in this case, which arbitrarily limits the interest expense deduction of an indisputably unitary business. Even those members whose companies are not doing business in Kansas are, almost without exception, engaged in interstate commerce. Consequently, they benefit from, and are entitled

to, the positive business environment assured by the Commerce and Due Process Clauses. Moreover, unless Kansas's attempt to skirt this Court's holding in *Hunt-Wesson* is thwarted, other States may be emboldened to follow suit, thereby vitiating the protections afforded by the Constitution.

Because TEI members and the businesses by which they are employed will be materially affected by the Court's decision whether to review this case, the Institute has a special interest in the outcome of this case.

SUMMARY OF ARGUMENT

1. Last term, this Court unequivocally and unanimously held that a State cannot do indirectly—by denying a legitimate business expense deduction—what it is forbidden to do directly—taxing income that is earned outside its jurisdiction. *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). Like the California statutory scheme struck down in *Hunt-Wesson*, the State of Kansas's attempt to indirectly tax income that it has no right to reach should fail.

2. To effect a "fair apportionment," the States have developed formulae to determine what part of a taxpayer's income is part of its "unitary" business and therefore may be taxed by the respective States. The purpose of any apportionment formula is to assign to the taxing State the amount of taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State. If a State errs or overreaches in defining a taxpayer's unitary business—for example, by including nonapportionable items of income in or excluding apportionable items of expense from the tax base—its formula will violate constitutional norms. *See Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992).

The constitutional issue in this case is whether the State of Kansas's disallowance of a deduction for interest paid by an

out-of-state company to replace current debt and to thwart a hostile takeover does violence to the unitary business principle and hence contravenes the U.S. Constitution by effectively taxing income beyond the State's constitutional reach. Just last term, this Court unanimously struck down a California statute that sought to deny a taxpayer a deduction for interest on the grounds that all borrowings by the taxpayer supported its nonunitary investments. The Court found such an assumption constitutionally beyond the pale. *Hunt-Wesson*, 528 U.S. at 465. At a minimum, the holding in *Hunt-Wesson* calls into question the propriety of the State's action here. *Amicus* TEI respectfully submits that decision, which the court below did not even mention, undermines completely the State's action.

3. During the years in issue in this case, the State of Kansas used the so-called transactional test for determining business income, the controlling factor for which is the nature of the particular transaction giving rise to the income. To constitute business income, the transaction and activity must be incurred in the regular course of the taxpayer's business operations.

In this case, the Kansas Board of Tax Appeals disallowed as an apportionable business expense the debt service incurred by the Kroger Company, among other things, to fend off a hostile takeover attempt. (App. at 2a).[2] The taxpayer appealed, and the Kansas Supreme Court affirmed, holding that "the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense." (App. at 15a.) It is this characterization that is at issue here.

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[2] "App." references are to the various appendices bound with the Petitioner's Petition for a Writ of Certiorari to the Supreme Court of Kansas in *The Kroger Co. v. The Kansas Department of Revenue*, No. 00-1422 (filed March 12, 2001).

4. More than a century and a half ago, this Court confirmed that "a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *The Passenger Cases* (*Smith v. Turner*), 48 U.S. (7 How.) 283, 458 (1849). In *Allied-Signal*, the Court confirmed the unitary business principle, while validating the "necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. Last year, the Court revisited the unitary business principle in the context of a deduction. In *Hunt-Wesson*, this Court considered whether the Constitution permitted the State of California to carve out an exception to its interest expense deduction, which it measured by the amount of nonunitary dividend and interest income that a nondomiciliary corporation had received. 528 U.S. at 464. Because "that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax," the Court held that the statutory scheme was unconstitutional. *Id.* at 465.

The failure of the State of Kansas to reasonably apportion Kroger's interest expense in this case should likewise fail. The borrowings that gave rise to the interest expense here benefitted Kroger's unitary business and, therefore, were related to, and permitted the continuation of, "the taxpayer's regular trade or business." For the State to assert otherwise suggests either that it misapprehends the distinction between business and nonbusiness income or that it is driven less by adherence to constitutional principles than by a desire to maximize its revenues from nondomiciliary companies.

The cases relied on by the State—which all involved either a cessation of a taxpayer's business or other significant change in its corporate structure—are inapposite. Here, the taxpayer disposed of no stock and effected no changes in its corporate structure. Rather, it engaged in transactions (borrowings) that are an integral part of its regular trade and

business and that, not coincidentally, permitted the taxpayer's unitary business to remain intact. Accordingly, the interest incurred as a result of those borrowings should be properly taken into account in determining the taxpayer's apportionable income.

5. The Commerce and Due Process Clauses operate as a constitutional brake on the State's efforts to tax extraterritorial income. Having been blocked in their attempts to do this directly, some States (such as California in *Hunt-Wesson*) have turned to a denial of legitimate business deductions. Kansas's attempt here to reach Kroger's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The State's disallowance of Kroger's interest expense deduction should not be condoned.

ARGUMENT

I.

This is not a difficult case. Last term, this Court unequivocally and unanimously held that a State cannot do indirectly—by denying a legitimate business expense deduction—what it is forbidden to do directly—taxing income that is earned outside its jurisdiction. *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000). Like the California statutory scheme struck down in *Hunt-Wesson*, the State of Kansas's denial of an interest deduction here represents nothing more than a backdoor attempt to tax indirectly income that it has no right to reach. Its attempt should fail and, accordingly, the decision below should be reversed.

II.

This is the latest in a series of cases to come to the Court on the question of what connection, or nexus, must exist between a State and a nondomiciliary taxpayer's income from out-of-state sources or activities before that income can be

apportioned to, and therefore taxed by, the State. In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the Court confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Id.* at 460. To effect such a "fair apportionment," the States have developed formulae to determine what part of a taxpayer's income may be properly taxed by the respective States. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA)—which the State of Kansas has adopted—the formula compares (1) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (2) the taxpayer's total property, payroll, and sales. UDITPA §§ 9-17. The purpose of any apportionment formula is to assign to the taxing State the amount of taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State.

The general permissibility of formulary apportionment, however, should not obscure or minimize the Constitution's limitation on the States' ability to tax out-of-state income. As the Court held in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), "[u]nder both the Due Process and the Commerce Clauses of the U.S. Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its border.'" *Id.* at 164 (*quoting ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982)). The Court continued in *Container* that dividing income among the several States resembles "slicing a shadow." *Container Corp.*, 463 U.S. at 192. Absolute consistency among taxing authorities "may just be too much to ask," *id.*, but there are indisputable constitutional limits on a State's use of a given formula to tax income derived from

interstate commerce.[3] In other words, although having discretion, no State has *carte blanche*, either in devising or applying its apportionment scheme. The shadow must be sliced, and it must be sliced fairly. If the State has not "given anything for which it can ask return" in respect of the person, property, or transaction it seeks to tax, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940), the Commerce and Due Process Clauses operate to limit the State's raw power to tax. *See Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (the Court has a duty "to make the delicate adjustment between the national interest in free and open trade and the legitimate interest of the individual States in exercising their taxing powers").

For more than a century, the key to the Court's constitutional analysis has been the application of the unitary business principle, which focuses on whether the out-of-state item that the State is seeking to tax is "unitary" with, or functionally related to, that taxpayer's in-state activities. In *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980), the Court explained that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439 (footnote omitted). Hence, unless the unitary business principle is correctly applied, the apportionment formula employed by the State could render a constitutionally impermissible result. The unitary tax principle calculates the local tax base by "first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary

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[3] In evaluating challenges to state taxing schemes, the task is to examine whether the challenged tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977).

business' between the taxing jurisdiction and the rest of the world" based on a formula "taking into account objective measures of the corporation's activities within and without the jurisdiction." *Container Corp.*, 463 U.S. at 165.[4] If a State errs or overreaches in defining a taxpayer's unitary business—for example, by including nonapportionable items of income in or excluding apportionable items of expense from the tax base—its formula will violate constitutional norms. *See Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772-73 (1992).[5]

The overarching constitutional issue in this case is whether the State of Kansas's disallowance of a deduction for interest paid by an out-of-state company to replace current debt and to successfully resist a hostile takeover effort does violence to the unitary business principle and hence contravenes the Commerce and Due Process Clauses by effectively taxing income beyond the State's constitutional reach.[6] Just last term, the Court in *Hunt-Wesson* unanimously struck down a California statute that sought to deny a taxpayer a deduction

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[4] Although the terms "allocation" and "apportionment" are often used interchangeably in respect of the division of income among various jurisdictions, "allocation" properly refers to the "attribution of a particular type of income to a designated state, [and] 'apportionment' refers to the division of the tax base by formula." JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, STATE TAXATION I: CORPORATE INCOME AND FRANCHISE TAXES ¶ 9.01 (3rd ed. 1998).

[5] In *Allied-Signal*, the Court explained that "the unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780; *see id.* at 778 ("[T]here must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax.").

[6] U.S. CONST. art. I, § 8, cl. 3 (Commerce Clause); U.S. CONST. amend XIV, § 1 (Due Process Clause).

for interest on the grounds that all borrowings by the taxpayer supported its *non*unitary investments. The Court found such an assumption constitutionally beyond the pale. At a minimum, the holding in *Hunt-Wesson* calls into question the propriety of the State's action here. Indeed, *amicus* TEI respectfully submits that decision, which the court below did not even acknowledge, undermines the State's action completely.

III.

Like many states, Kansas imposes a corporate franchise tax for the privilege of doing business in the State, which starts with the corporation's federal taxable income and is modified to reflect the net income derived from or attributable to sources within the State. KAN. STAT. ANN. § 79-32,138 (App. at 99a-100a). To effect the proper apportionment of income to the State, Kansas generally uses the UDITPA apportionment formula. KAN. STAT. ANN. § 79-3279 (App. at 98a); UDITPA §§ 9-17. Under UDITPA and similar statutes, "business income" is apportioned among all the States in which the taxpayer does business, and "nonbusiness income" is allocated to the taxpayer's state of domicile. *See* KAN. STAT. ANN. §§ 79-3274 through 79-3278 (App. at 94a-97a). Accordingly, the definitions of those terms are critically important.[7]

During the years in issue, the State of Kansas used the so-called transactional test for determining business income, the

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[7] During the years at issue, KAN STAT. ANN. § 99-3271(a) mirrored UDITPA § 1(a), which defined "business income" to mean "[i]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (App. at 93a.) KAN STAT. ANN § 99-3271(e), following UDITPA § 1(e), provided that "nonbusiness income" is "all income other than business income." (App. at 94a.)

controlling factor for which is the nature of the particular transaction giving rise to the income. To constitute business income, the transaction and activity must be incurred in the regular course of the taxpayer's business operations. *Western Natural Gas v. McDonald*, 446 P.2d 781 (Kan. 1968).[8] In this case, the Kansas Board of Tax Appeals disallowed as an apportionable business expense the interest expense incurred by the Kroger Company, among other things, to fend off a hostile takeover attempt. (App. at 2a).[9] The Board classified the expense as a nonbusiness expense, which was allocated to Kroger's state of commercial domicile (Ohio). The taxpayer appealed, and the Kansas Supreme Court affirmed, holding that "the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense." (App. at 15a.) It is this characterization of Kroger's legitimate interest expense—which significantly increases its Kansas tax liability—that is at issue here.

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[8] For a general discussion of the differences between the "transactional" and "functional" tests for defining "business income," *see* JEROME R. HELLERSTEIN & WALTER HELLERSTEIN, *supra*, ¶¶ 9.05[2][a] through 9.05[2][c]. Although the States have discretion to adopt a definition of business (or apportionable) income that is *narrower* than the Constitution permits and although both the transactional and the functional tests can produce constitutionally acceptable results, there is no guarantee that the application of either definition in particular cases will comport with the unitary business principle and the dictates of the Court's state taxation jurisprudence. *See id.* ¶ 9.05[1][b]. In other words, the definitions of business income and constitutionally apportionable income are similar, but not necessarily coextensive.

[9] Although the court below stated that all the debt was incurred in connection with management's decision to resist the takeover attempt (App. at 2a), that was not the case. Only 80 percent of the debt was used for that purpose; the remaining 20 percent was used to retire existing long-term debt. (App. at 77a.)

IV.

The State of Kansas here does not stake a claim to taxing directly the nonbusiness (that is to say, nonapportionable) income of a nondomiciliary taxpayer. Rather, the State seeks to tax the income indirectly by disallowing a deduction for interest expense that the Kroger Company incurred in the regular course of its unitary business. Such a taxing scheme cannot withstand scrutiny, especially in the aftermath of the Court's decision in *Hunt-Wesson*.

More than a century and a half ago, the Court confirmed that "a State cannot do that indirectly which she is forbidden by the Constitution to do directly." *The Passenger Cases* (*Smith v. Turner*), 48 U.S. (7 How.) 283, 458 (1849). This principle that a State may not, through sleight of hand, indirectly tax constitutionally protected income continues to have vitality today. Thus, in *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388, 404-05 (1984), the Court found that it is irrelevant that a State discriminates against business carried on outside the State by disallowing a tax credit rather than by imposing a higher tax. *Accord National Life Ins. Co. v. United States*, 277 U.S. 514, 520 (1928) ("What remains after subtracting all allowances is the thing really taxed."). More to the point, formal distinctions lacking in economic substance have no constitutional significance. *Westinghouse Electric Corp.*, 466 U.S. at 405. As the Court noted last term in *Hunt-Wesson*, "[a] tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes." 528 U.S. at 464 (*quoting Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991) (citation omitted)). *Cf. Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282-83 (1924) (States' efforts to tax income from non-unitary entities must not be "a mere effort to reach profits earned elsewhere under the guise of legitimate taxation").

In *Allied-Signal*, the Court confirmed the unitary business principle, while validating the "necessary limit on the States'

authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. There, in asking the Court to jettison the unitary business principle, the State argued that multistate corporations regard all their holdings as asset pools and therefore any distinction between operational and investment assets is artificial and should be ignored. 504 U.S. at 784-85. This Court wisely rejected this strained contention, noting instead that the relevant inquiry must focus on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785.

Last year, the Court revisited the unitary business principle in the context of a deduction. In *Hunt-Wesson*, this Court considered whether the Constitution permitted the State of California to carve out an exception to its interest expense deduction, which it measured by the amount of nonunitary dividend and interest income that a nondomiciliary corporation had received. The statute did not directly impose a tax on nonunitary income; rather, it denied the taxpayer the use of a portion of an interest deduction from unitary income. 528 U.S. at 464.

The State in *Hunt-Wesson* sought to justify its taxing scheme on the grounds that it prevented a corporation from borrowing to support its business needs, while freeing the company to use unencumbered funds to purchase nonunitary business assets. Although positing that "[i]f California could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income, the limit would not, in fact, be a tax on nonunitary income," 528 U.S. at 465, the Court struck down the statute as unconstitutional. There was no factual support for California's facile argument, only its hollow assertion: "The California statute . . . pushes this concept past reasonable bounds. In effect, it assumes that a corporation that borrows any money at all has really borrowed that money to purchase or carry its nonunitary

investments." 528 U.S. at 466 (citations and internal quotation marks omitted). Because "that which California calls a deduction limitation would seem, in fact, to amount to an impermissible tax," the Court held that the statutory scheme was unconstitutional. *Id.* at 465.

At bottom, *Hunt-Wesson* was a simple case of a State's failing to adopt a reasonable expense allocation method, thereby impermissibly taxing income beyond its jurisdiction. A similar failing by the State of Kansas here should lead to the same result: invalidation of the State's denial of the taxpayer's interest deduction as unconstitutional. Here, the State seeks to justify its denial of Kroger's interest deduction on the grounds that the underlying debt was not incurred in the normal course of business. Hence, the Kansas Supreme Court concluded that "[the Board of Tax Appeals] is correct that under the transactional test [for defining 'business income'], the borrowing of money to defend against a hostile takeover is not an expense in the regular course of business, and the resulting interest expense is a nonbusiness expense [that is nonapportionable]." (App. at 15a.)

This line of argument, this attempt at misdirection, must fail for several reasons. First, as Board member Robert Frey observed in his dissent from the interest denial decision, hostile takeovers may not occur often, but the defense against them is not unrelated to the taxpayer's business activities: "Financial management of a publicly held corporation is something that must be done in the regular course of taxpayers' trade or business." (App. at 72a-73a). Indeed, he observed, incurring the debt was an "astute business decision that possibly saved the company." (App. at 73a.)[10] To be sure, takeover attempts do not occur every day, but in this

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[10] Moreover, 20 percent of the debt (and, therefore, 20 percent of the interest incurred) was used to retire debt that the taxpayer accumulated through the course of its operations for which the State previously permitted a deduction. (App. at 77a.)

case the taxpayer's successful defense against the attempt allowed the taxpayer to maintain its operations in the State. In other words, the borrowings that gave rise to the interest expense benefitted the unitary business and, therefore, were related to, and permitted the continuation of, "the taxpayer's regular trade or business." For the State to assert otherwise regrettably suggests either that it misapprehends the distinction between apportionable (business) and allocable (nonbusiness) income or that it is driven less by adherence to constitutional principles than by a desire to maximize its revenues from nondomiciliary companies.

Second, although the denial of a portion of Kroger's interest expense might be constitutionally permissible if the State "could show that its deduction limit actually reflected the portion of the expense properly related to nonunitary income," *Hunt-Wesson*, 528 U.S. at 465, it makes no such showing here. Indeed, its position is supported not by any facts, but merely a grand assertion. It seeks to convert Kroger's legitimate interest expenses into nonbusiness, nonapportionable items simply by arbitrarily wishing it so. As the Court held last year in *Hunt-Wesson*, this approach does not pass constitutional muster.[11] This conclusion is supported by the parties' stipulation that the taxpayer treated its interest expense on its Kansas returns in exactly the same manner as it treated the expense on the returns it filed with 30 other states. (App. at 77a.) Like the State of California in *Hunt-Wesson*, the State of Kansas stands alone in arbitrarily disallowing a deduction for *all* of Kroger's interest expense. Its action is not reasonable and constitutes "impermissible

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[11] "A state tax code that unrealistically assumes that every . . . borrowing [by a business with taxable and nontaxable income] first helps [generate the nontaxable income] . . . fails to 'actually reflect a reasonable sense of how income is generated.'" *Hunt-Wesson*, 528 U.S. at 466 (*quoting Container Corp.*, 463 U.S. at 169).

taxation of income outside its jurisdictional reach." *Hunt-Wesson*, 528 U.S. at 468.

Third, the cases relied on by the State to support its distention of the nonbusiness income concept are inapposite. Specifically, the state court cites several decisions in which the taxpayer successfully argued that a gain was so extraordinary that it should not be classified as business income and hence subject to apportionment pursuant to UDIPTA. *See Robert Half International, Inc. v. Franchise Tax Board*, 78 Cal. Rptr. 2d 453 (1998); *Phillips Petroleum v. Department of Revenue*, 511 N.W.2d 608 (Iowa 1993); *Hercules, Inc. v. Commissioner of Revenue*, 575 N.W.2d 111 (Minn. 1998); *Union Carbide Corp. v. Huddleston*, 854 S.W.2d 87 (Tenn. 1993). (App. at 9a-13a.) The State then asserts that the reciprocal of that argument should also obtain: Where a deduction is "extraordinary," it too should be allocated to the taxpayer's state of domicile and not apportioned among the States.

This argument proves too much. First, it ignores the fundamental difference between items of income and expense. Expense items must be related to income items; they do not stand on their own. Thus, KAN. STAT. ANN. § 79-3274 (App. at 94a-95a) provides that "[a]llocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the income year." Again, the key term is "related expenses," for expense items must be associated with, or "related to" items of income. To what nonbusiness income does the taxpayer's interest expense relate? It is a question that the State does not deign to answer.

More fundamentally, the cases relied on by the State all involve a cessation of business or other significant changes in the taxpayer's corporate structure. Hence, in *Phillips Petroleum*, the issue was the character of gain resulting from

the sale of gas and oil producing assets; in *Hercules, Inc.*, it was gain from the sale of stock in a corporation; and in *Union Carbide Corp.*, the issue involved gain realized upon the sale and liquidation of seven distinct lines of business, the gains from which were not reinvested in ongoing business operations. The fourth case cited by the court, *Robert Half International*, involved the taxpayer's purchase and cancellation of warrants, which had the effect of materially changing the corporation's structure. *See* Bruce Daigh, Garland Allen & Christopher Witney, *The UDIPTA Business Income Definition and the Cessation-of-Business Concept*, 20 STATE TAX NOTES No. 13, 2001-STT 58-39 (March 26, 2001).

The cessation-of-business cases, however, have no application here, not only because they dealt with gains (not expenses that must be related to specific items of income), but because the transactions giving rise to the gain effected changes in the corporate structure.[12] Here, the taxpayer disposed of no stock and effected no changes in its corporate structure. Rather, the taxpayer engaged in transactions (borrowings) that are an integral part of its regular trade and business and that, because they had the effect of fending off a hostile takeover attempt, permitted the taxpayer's unitary business to remain intact. Accordingly, the interest incurred as a result of those borrowings should be properly taken into

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[12] There are several other cases supporting this analysis. *See e.g. Chief Industries Inc. v. Indiana Dep't of Revenue*, Indiana Tax Court, No. 49T10-9711-TA-193 (Oct. 24, 2000) (capital gain generated on the sale of stock held to be nonbusiness income); *Uniroyal Tire Co. v. Alabama Dep't of Revenue*, Ala. No. 1981928 (Aug. 4, 2000) (gain from the complete liquidation of a corporation's business operations following the sale of a partnership interest held to be nonbusiness income). *See generally* Jordan M. Goodman & Brian L. Browdy, *The Apportionability of Liquidation Gain in Light of Lenox, Inc.*, 11 J. MULTISTATE TAXATION AND INCENTIVES 6 (March/April 2001).

account in determining the taxpayer's apportionable income.[13]

V.

The Commerce Clause and Due Process Clause operate as a constitutional brake on the States' efforts to tax extraterritorial income. *See, e.g., Allied-Signal*, 504 U.S. at 789 (striking down a New Jersey attempt to tax gain realized from a stock sale); *ASARCO Inc.*, 458 U.S. at 328 (striking down Idaho's attempt to include dividends, interest, and capital gains from a subsidiary in the parent corporation's income); *F.W. Woolworth Co. v. Taxation and Revenue Dep't of New Mexico*, 458 U.S. 354, 373 (1982) (striking down New Mexico's taxation of dividends received from the taxpayer's foreign subsidiary). Having been blocked in their efforts to tax such income directly, some States (such as California in *Hunt-Wesson*) turned to a denial of legitimate business deductions. *See, e.g., Hunt-Wesson*, 528 U.S. at 460. *See also* OHIO REV. CODE ANN. § 5733.042 (restricting the deductibility of royalties and interest expense between related entities); CONN. GEN. STAT. § 12-218c (same). The State of Kansas's action in this case thus reflects a disturbing trend among the States to tax extraterritorial income by denying legitimate business deductions. This pattern should be stopped.

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[13] An attention-grabbing feature of this case is the extremely large amount of money that the taxpayer borrowed: $4.1 billion. Although the court below never specifically linked the size of the borrowings to its characterization of the interest expense as "extraordinary," the magnitude of the expenditures cannot be ignored. *See* App. at 71a (Dissent of Board Member Robert G. Frey) ("If there is anything unique about the expense in this case it is the size of the loan negotiated by the company and the resulting debt service expense.") *Amicus* TEI submits, however, that in construing the terms "business income" and "nonbusiness income," the term "extraordinary" is better understood to relate not to the quantum but rather the character of the item involved.

This Court "act[s] as a defense against state taxes which, whether by design or inadvertence, . . . attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions." *Trinova Corp.*, 498 U.S. at 386. As Robert Frey, a member of the Kansas Board of Tax Appeals, explained in his dissent below: "The result of the removal of the interest expense [from Kroger's income] as an 'ordinary business expense' is a substantial penalty, interest and tax, which must be paid by the corporation to the State of Kansas." (App. at 70a). Kansas's attempt to reach Kroger's nontaxable income by reducing its interest expense has the same effect as a direct tax on that income and cannot in fairness be sustained. The State's disallowance of Kroger's interest expense deduction should not be condoned.

CONCLUSION

For the foregoing reasons, the Court should grant the petition for a writ of certiorari and reverse the decision below.

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April 11, 2001